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No. 286

In the Supreme Court of the United States

OCTOBER TERM, 1955

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SOUTHWEST EXPLORATION COMPANY, a Corporation

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 75-104) are reported at 18 T. C. 961. The opinion of the Court of Appeals (R. 125-129) is reported at 220 F. 2d 58.

JURISDICTION

The judgment of the Court of Appeals (R. 130) was entered on March 7, 1955. By order of Mr. Justice Douglas, dated May 27, 1955, the time for filing a petition for a writ of certiorari was ex-

tended to August 4, 1955. (R. 130.) The petition for a writ of certiorari was filed on August 2, 1955, and was granted on October 10, 1955. (R. 131.) The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254 (1).

QUESTION PRESENTED

Taxpayer obtained a lease from the State of California to drill for and produce oil from certain submerged lands. By state law, taxpayer was required to drill the wells on a slant from uplands adjacent to the costal area and, as a condition to obtaining the lease, taxpayer was required to secure necessary easements from the upland owners permitting it to conduct the drilling and production operations from and through their property. In return for securing such easements from certain upland owners, taxpayer undertook to pay them 24½ percent of its net profits derived from the extraction of oil from the submerged lands.

The question is whether taxpayer's depletable interest includes the net profit payments which it made to the upland owners, as was held by the court below, or, on the contrary, whether the upland owners are entitled to depletion deductions on these payments to the exclusion of taxpayer, as was held by the Court of Claims in a companion case involving one of the upland owners and which is also before this Court in No. 287.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations (Section 23 (m) and 114 (b)(3) of the Internal Reve-

nue Code of 1939, Sections 87 (a) and 89 of California State Lands Act of 1938, Statutes of California (Extra Session 1938), c. 5, and Section 29.23(m)-1 of Treasury Regulations 111) are set forth in the Appendix, *infra*, pp. 45-49.

STATEMENT

The undisputed facts may be summarized as follows:

In 1938, the State of California enacted the State Lands Act of 1938 to control the exploitation of oil deposits in the lands belonging to the state. (R. 109.) The Act provided that any lease of submerged state land shall contain a provision that (Sec. 87 (a))—

> Each well drilled pursuant to the terms of [the] lease shall be drilled only upon filled lands or shall be slant drilled from an upland or littoral drill site to and into the subsurface of the tide or submerged lands covered by the lease.

The lease was further required to provide that all machinery be located on, and all surface operations be conducted from, such filled lands or uplands. (*Ibid.*)

From August 8 to 13, 1938, the State Lands Commission published a "Notice of Intention of State Lands Commission to Receive Offers to Enter into an Agreement or Agreements for Extraction of Oil and Gas and Other Hydrocarbons from Certain Tide and Submerged Lands of the State, Situate in Orange County, California" (hereinafter referred

to as the "Notice"). (R. 5-6, 21-24, 79.) The area covered by the Notice consisted of approximately 835 acres of submerged land lying off Huntington Beach, California. (R. 79.) There were no "filled lands" usable or available in connection with the extraction of oil and gas from this area. (R. 8, 90.)

The Notice stated that each bidder, as a condition precedent to consideration of his bid, had to present satisfactory evidence of his ability to furnish all necessary sites and rights-of-way. This evidence was to include (1) an endorsement by the owners of the uplands on the proposed agreement acknowledging that the bidder had the necessary sites, rights-of-way and easements, and (2) the originals, or copies, of the instruments vesting in the bidder the necessary sites, rights-of-way and easements. (R. 21-22.)

On August 25, 1938, taxpayer entered into an agreement with the owners of the uplands adjacent to the 835 acres of submerged land covered by the Notice. These owners were the Huntington Beach Company, the Pacific Electric Railway Company, the Pacific Electric Land Company, the Bolsa Land Company, the Bolsa Chica Gun Club, and the Standard Oil Company of California. Under this agreement taxpayer was permitted to go on the uplands, to open the tops of its oil wells from the uplands, to drill into the land and under the land, and to place its machinery on the surface of the lands. (R. 6, 89.) A second, contemporaneous agreement between taxpayer and four of the upland owners covered the surface location and sub-

surface course of the wells to be drilled through these uplands. (R. 9, 49-58, 89-90.)

On August 30, 1938, taxpayer submitted its bid to the State Lands Commission. (R. 7, 79-80.) It annexed to its bid a form of "Agreement for State Easement" which bore the following endorsement by each of the upland owners (R. 7, 47-48):

> Endorsement of Uplands Owner
>
> The owner or owners of real property described in this agreement as the "uplands" hereby acknowledge that the Grantee named in this agreement has been granted all necessary rights-of-way and easements, in and through the uplands necessary for the performance upon the part of the Grantee of the covenants, and the observance upon the part of the Grantee of the conditions, herein set forth, and the said owner or owners hereby consent to all operations upon the uplands specified and contemplated by the provisions of this agreement.

Also attached to the bid was the agreement giving taxpayer permission to use the uplands for its drilling operations. (R. 7, 80.)

On September 26, 1938, taxpayer's bid was accepted and it entered into "Agreement for State Easement No. 392". (R. 8, 24-49, 80.) This agreement, as required by the State Lands Act of 1938, contained a provision requiring all wells to be slant drilled from the uplands and requiring all machin-

cry to be located on, and all operations to be conducted from, such uplands. (R. 35.)

The following day, September 27, 1938, taxpayer entered into a third agreement with the Pacific Electric Railway Company, the Pacific Electric Land Company, and the Huntington Beach Company. (R. 59-74, 90.) The stated purpose was to "provide a manner of computation and distribution of rental for the rights and privileges" given by these upland owners and others to the taxpayer in the two agreements entered into on August 25, 1938. (R. 60.) The agreement provided that taxpayer should pay the other parties to the agreement "as rental an amount equal to the following percentages of the 'net profits' " from the extraction of oil from the lands covered by the state easement (R. 68):

17.75% to Huntington Beach Company.
1.576% to Pacific Electric Railway Company.
5.174% to Pacific Electric Land Company.

The agreement contained elaborate provisions governing the calculation of the net profits. These net profits were defined as the "gross proceeds" from the taxpayer's operations on a designated portion of the state lands minus "chargeable expenses." The gross proceeds included the sale value of all oil produced and saved and all gas produced and sold, and 50 percent of the value of all gasoline extracted from gas, minus state royalties, plus the proceeds of rental of equipment, etc., the cost of which had been included within chargeable

expenses. (R. 62-63.) The chargeable expenses embraced all normal operating costs. (R. 64-66.)[1]

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[1] In addition this agreement contained the following provisions (R. 70-71, 72-73):

> 13. It is understood and agreed that nothing herein shall add to, modify, or limit the privileges given to Southwest by Second Parties and others in those certain agreements dated August 25, 1938, or the rights given to Southwest under said State Easement, nor shall any default hereunder by Southwest cause a forfeiture of the rights or privileges given Southwest by Second Parties under said agreements of August 25, 1938.
>
> 14. All operations performed by Southwest in connection with the development and operation of said described lands shall be at the sole cost and expense of Southwest, and Second Parties shall not be chargeable with nor liable for any part thereof. None of the amounts paid to Second Parties hereunder shall be returned to Southwest should there be a subsequent loss in the development and operation of said lands, provided that if said State Easement and the privileges given Southwest under said agreements of August 25, 1938, and referred to herein, are terminated otherwise than as provided therein and a loss results to Southwest therefrom, then each Second Party shall repay to Southwest the following percentages of such loss; as to Huntington Beach Company, 17.75%; as to Pacific Electric Land Company, 5.174%; and as to Pacific Electric Railway Company, 1.576%; provided that none of Second Parties shall be required to pay, in any event, more than has been received by such Second Party hereunder.
>
> * * * * *
>
> 19. This agreement shall not be construed to give Second Parties any right, title or interest in said State Lands or in or under said State Easement, and said Southwest may, at any time, at its election, without any consent or participation by Second Parties, modify said State Easement or surrender, and terminate the same in accordance with the provisions thereof. In the event that Southwest shall assign its interest in State Easement, such assignment shall be made subject to the assumption

All surface operations in connection with the drilling and operation of wells covered by taxpayer's State Easement No. 392 were conducted on the land owned by the Huntington Beach Company. All subsurface operations and wells went through the land of that company and the lands of the Pacific Electric Land Company and the Pacific Electric Railway Company. (R. 15.)

During the taxable years in question, 1939-1945, 24.5 percent of the net profits were paid the Huntington Beach Company, the Pacific Electric Railway Company and Pacific Electric Land Company, pursuant to the agreement of September 27, 1938. (R. 16, 19-20.)

Determination of taxpayer's federal tax liabilities [2] involved the question whether taxpayer was

---

by the assignee thereunder of all of the obligations of Southwest under this agreement.

* * * * * *

22. This agreement and the two said agreements of August 25, 1938, and any and all rights of Southwest in or to the property covered thereby, shall terminate upon the expiration of said Easement No. 392 or any renewals, extensions, or modifications thereof. Upon such termination, Southwest shall proceed diligently to remove any and all facilities which it may have placed upon said uplands and shall forthwith restore said uplands as nearly as possible to the condition in which said premises existed prior to the commencement of operations thereon by Southwest. Southwest shall immediately upon such termination pay to Second Parties whatever sums of money which may then be due them.

23. It is the express intention of the parties hereto not to create a partnership relationship.

[2] The taxes involved are income, declared value excess profits and excess profits taxes.

required (as asserted by the Commissioner) to exclude from its gross income, on which percentage depletion was allowable, the net profit payments made to the upland owners. The Tax Court, reasoning that the upland owners did not acquire any depletable interest by virtue of the net profit payments, held that taxpayer was not required to exclude those payments from its depletion base. (R. 97-104.) The Court of Appeals affirmed in a *per curiam* opinion which adopted relevant extracts from the Tax Court's opinion. (R. 125-129.)

SUMMARY OF ARGUMENT

I

The taxpayer is the lessee and the State of California is the lessor of oil and gas leases to certain submerged lands. Because of the requirements of state law and because no other property was available, the wells were required to be slant drilled through upland property and all drilling and production operations were required to be conducted from the surface of such upland property.

In order to qualify as a bidder for the lease, the taxpayer acquired the necessary sites, easements and rights-of-way from the owners of the upland properties. In return, it undertook to pay them a total of 24½ percent of its net profits derived from the production of oil and gas from these wells.

It is the Commissioner's position that the upland owners acquired a depletable interest and are entitled to percentage depletion on the net profit pay-

ments made to them by the taxpayer. It necessarily follows that the taxpayer is not entitled to percentage depletion on the same payments, i.e., it must exclude those payments from the gross income from the property on which its percentage depletion is computed. Consequently, the Court of Appeals and the Tax Court were wrong in reaching the opposite conclusion and in holding that the taxpayer's depletable income from the property included all the income except for the royalties paid to the State of California.

In the peculiar circumstances of this case, the upland owners contributed valuable property rights which were essential to the taxpayer's production of oil and gas from the deposits. In a practical sense, the contribution made by the upland owners was not different from that made by a lessor or assignor who possesses the exploitation rights to the mineral deposits and transfers them to the operator in return for the right to receive a portion of the operator's net profits. Under the decisions in *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, and *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, the right to receive a portion of the operator's net profits is depletable when the recipient has transferred exploitation rights to the operator. In this case, too, the right of the upland owners to share in the operator's net profits is depletable since, by granting the use of their property to permit the drilling of the wells and the production of oil and gas, they stand virtually in the same posi-

tion as did the net profit recipients in the *Kirby* and *Burton-Sutton* cases.

The reasons relied on by the courts below for their conclusion that the upland owners lacked a depletable interest are not persuasive. Thus, the fact that the upland owners did not have legal title to the deposits, did not have the right to produce the oil and gas and did not make a cash investment in the mineral deposits, do not furnish a solid basis for the conclusion that the upland owners did not have a depletable interest. Indeed, the decisions of this Court uniformly demonstrate that these are not sufficient reasons for denying the upland owners the depletion deduction. Nor can the upland owners be denied the deduction because, as the court below reasoned, the State of California might some day change its law and permit vertical drilling to these deposits. The depletion interest of the parties should be determined under existing facts and not by reference to possible factual changes which have not yet taken place, which may never happen, and which are beyond the control of the immediate parties.

II

If the Court disagrees with our contention under Point I that the upland owners' right to share in the taxpayer's net profits was a depletable interest because the upland owners made a contribution of the use of their property which was essential to the production of oil and gas, we urge, alternatively, that it be held that the upland owners acquired a

depletable interest merely from the fact that they became entitled to share in the operator's net profits. It would be a logical extension of the principles applied in *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, and *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, to hold that any person who acquires the right to share in the net profits derived from the production of oil and gas has a depletable interest, and that it is immaterial how that interest was acquired. In other words, we believe the rule should be clearly stated that one who acquires such a right, whether it be by purchase, gift, or inheritance has acquired a depletable interest. A right to share in net profits would then stand on the same footing with a royalty interest which is measured by gross production. While the broad rule for which we here contend cannot be reconciled with the decisions in *Helvering* v. *O'Donnell*, 303 U.S. 370, and *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372, it is believed that those decisions are out of harmony with the *Kirby* and *Burton-Sutton* cases and should be regarded as no longer authoritative.

ARGUMENT

I

The Taxpayer Does Not Possess the Sole Depletable Interest. A Portion of the Depletable Interest Is In Upland Owners Since the Taxpayer Had to Drill Through Their Property and, In Return, Pays Them A Portion of Its Net Profits From the Production of the Oil

A. *Introduction*

The ultimate issue in this case involves conflicting claims of competing taxpayers to a portion of the depletion allowance attributable to the production of oil and gas from wells operated by the taxpayer, as lessee. Specifically, the question is whether the lessee of the wells is entitled to percentage depletion on all the gross income which it derives from the lease, or whether adjoining landowners, through whose property the taxpayer found it necessary to drill to reach the oil deposits and on whose property the taxpayer's production activities take place, acquired a depletable interest to the extent that the taxpayer undertook to pay them, in return, a portion of the net profits from the production of oil and gas from the wells.

Faced with competing claims to the same deduction for depletion, the Commissioner took inconsistent administrative positions in order to prevent duplicate deductions and denied the disputed portion of the deduction to all the interested parties. The taxpayer in the present case successfully contested the Commissioner's determination in the Tax

Court which held that the taxpayer was entitled to percentage depletion on the entire income from the wells, less, of course, the royalties paid to the State of California, the lessor. (R. 97-104.) The court below affirmed the decision of the Tax Court in a *per curiam* opinion. (R. 125-129.)

Thereafter, one of the adjoining landowners, Huntington Beach Company, successfully contested in the Court of Claims the Commissioner's disallowance of its claim to a portion of the depletion deduction. The Court of Claims, disagreeing with the court below, ruled that the lessee (the taxpayer in the present case) would not be entitled to percentage depletion on the portion of its net profits paid to the adjoining landowners and held that the adjoining landowners were entitled to depletion computed on the payments received by them from the lessee. *Huntington Beach Co.* v. *United States*, 132 F. Supp. 718, certiorari granted, October 10, 1955, No. 287, this term.

Since review by this Court of both cases removes the previous danger to the revenue from conflicting decisions, the Commissioner now abandons his prior, technical position which resulted in opposite contentions in the court below and in the Court of Claims. It is the Commissioner's position in both these cases, for the reasons discussed in this brief, that the portion of its net profits which the lessee pays to the adjoining landowners must be excluded from the base on which the lessee computes percentage depletion. Consequently, the court below erred in arriving at the opposite conclusion. Ac-

ceptance of the Commissioner's position would lead, of course, to the conclusion that the Court of Claims was correct in holding, in the *Huntington Beach* case, that the adjoining landowners were entitled to deduct percentage depletion on the payments which they received from the lessee.

B. *General principles relating to the deduction for depletion*

Prior to a detailed discussion of the issue raised by the particular facts of this case and the related case involving Huntington Beach Company (No. 287, this term), it may be helpful to present a summary of the general principles relating to depletion which this Court has followed and which will furnish guidance in the present controversy.

1. Taxpayers who possess an interest in mineral bearing property and who extract and sell the mineral deposits are not considered as realizing gain on the sale of property. Instead, the income derived has been analogized to that realized in the course of a manufacturing business and is considered to be ordinary income. *Burnet* v. *Harmel*, 287 U.S. 103; *Von Baumbach* v. *Sargent Land Co.*, 242 U.S. 503; *Bankers Coal Co.* v. *Burnet*, 287 U.S. 308; *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103.

In the process of realizing income by the extraction and sale of minerals, there is, of necessity, a gradual exhaustion of the value of the mineral deposit. In order to reflect this physical and economic fact, Congress, although not constitutionally required to do so (*Stanton* v. *Baltic Mining Co.*,

supra), has permitted a deduction for depletion so that the investment in the mineral deposit may be recouped free of tax as income is realized concurrently with the exhaustion of the deposit. Administrative difficulties inherent in other methods of calculating depletion led Congress to provide for an allowance in the form of percentage depletion. *Helvering v. Twin Bell Syndicate*, 293 U.S. 312, 315-320; *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603. The deduction for percentage depletion is arbitrary in amount, being in the case of oil and gas wells, 27½ per cent of the gross income from the property, but not more than 50 per cent of the net income from the property. Code Section 114(b)(3) (Appendix, *infra*, pp. 45-46).

It should be emphasized, at this point, that a taxpayer who is entitled to a deduction for depletion and who elects to take percentage depletion is not limited to a recoupment of his actual monetary investment. Indeed, a taxpayer is allowed percentage depletion even though he never invested any money in acquiring his interest or even though his investment has already been recouped by way of prior deductions for depletion. See *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25, 34. If a taxpayer possesses the kind of interest which is depletable, percentage depletion is deductible as long as the taxpayer continues to derive gross income from the property.

2. Since the statute limits the deduction to 27½ per cent of the "gross income from the property", the aggregate allowance granted to all parties hav-

ing a depletable interest cannot exceed this percentage of the gross income from a particular mineral property. *Kirby Petroleum Co.* v. *Commissioner*, *supra*, p. 604; *Helvering* v. *Twin Bell Syndicate*, *supra*, p. 321; *Anderson* v. *Helvering*, 310 U.S. 404, 407. The statute "must be read in the light of the requirement of apportionment of a single depletion allowance". *Helvering* v. *Twin Bell Syndicate*, *supra*, p. 321.[3]

One of the questions which constantly arises, as it does in this case, is who are the parties who are entitled to share in this allowance and how is the deduction to be apportioned between them? The problem includes questions whether a taxpayer who possessed a depletable interest has transferred it to others so as no longer to be entitled to the deduction and whether a taxpayer, who previously had none, has acquired the requisite interest which is depletable.

The simplest situation, though the rarest, is where the owner of the property produces and sells the oil and possesses the entire depletable interest. In the more common situation the owner of the property will grant the right to exploit the minerals to someone else, receiving in return a rent or royalty. Here, too the issue is relatively simple. Code Section 23(m) (Appendix, *infra*, p. 45) provides that in the case of leases "the deductions

[3] It is this aspect of the statute which requires the conclusion in the present situation that either the lessee or the upland owners (but not both) are entitled to depletion on the payments made by the lessee to the upland owners.

shall be equitably apportioned between the lessor and lessee" and Code Section 114(b)(3) states that there shall be excluded from the gross income from the property "an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property." Accordingly, in this situation the lessee or assignee will be entitled to depletion on the gross income realized from the sale of the oil, less the rents or royalties paid which are depletable by the lessor or assignor. *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25, 33-34; *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 604; *Helvering v. Twin Bell Syndicate*, 293 U.S. 312, 321. Even though the statute only speaks of lessors and lessees, an assignor may be entitled to share in the depletion allowance along with the lessor, lessee, and assignee. *Burton-Sutton Oil Co. v. Commissioner, supra; Palmer v. Bender*, 287 U.S. 551.

It will be noted that even though, under concepts of local law, a taxpayer is not regarded as having acquired legal title to the minerals in place, he may, nonetheless, have acquired a depletable interest. *Burnet v. Harmel*, 287 U.S. 103; *Palmer v. Bender, supra; Lynch v. Alworth Stephens Co.*, 267 U.S. 364; *Bankers Coal Co. v. Burnet*, 287 U.S. 308. Similarly, a taxpayer may be entitled to depletion even though he no longer possesses legal ownership of the underlying minerals. *Palmer v. Bender, supra; Burton-Sutton Oil Co. v. Commissioner, supra*, pp. 32-33. Nor is a taxpayer's interest to be determined from the form of the particular instrument or from the formalities of the kind of convey-

ance made. *Burton-Sutton Oil Co.* v. *Commissioner*, *supra*, p. 32; *Palmer* v. *Bender*, *supra*, pp. 555-556; *Anderson* v. *Helvering*, 310 U.S. 404, 411.

3. It is a taxpayer's economic relationship, rather than his legal relationship to the oil or other minerals in place, which determines whether he possesses an interest which is exhaustible and on which he is entitled to the deduction for depletion. This interest has been described, in ultimate terms, as an "economic interest". As the Court said in *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 603, "only a taxpayer with an economic interest in the asset, here the oil, is entitled to the depletion." It also summarized the matter by saying in *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 32, "it is the owner of a capital investment or economic interest in the oil in place who is entitled to the depletion." See also *Anderson* v. *Helvering*, *supra*, and cases cited at pp. 407-408.

A taxpayer's "economic interest" which will support the deduction for depletion is described in this Court's latest pronouncement in *Burton-Sutton Oil Co.* v. *Commissioner*, *supra*, pp. 34-35, as follows:

> Depletion depends only upon production. It is the lessor's, lessee's or transferee's "possibility of profit" from the use of his rights over production, "dependent solely upon the extraction and sale of the oil," which marks an economic interest in the oil. See *Kirby Petroleum Co.* v. *Commissioner*, *supra*, p. 604.

Earlier, in *Palmer* v. *Bender*, 287 U.S. 551, 557, the Court said:

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. . . .

And further (p. 557):

> It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.

While it had long been established that a right to receive a fractional part of the minerals produced or of the gross proceeds from their sale represented an economic interest in the property which is depletable, *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, and *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, made it clear, contrary to the prior position of the Government, that the right to receive a portion of the net profits earned by the operator from production of the minerals could also qualify as an economic, depletable interest in the property.

C. By contributing the use of their land to enable the lessee to produce oil and gas from the deposits and by receiving, in exchange, the right to share in the profits derived from production of the minerals, the upland owners obtained an economic, depletable interest

We turn, next, to a consideration of the particular circumstances of this case to demonstrate why, under the general principles established by this Court, the upland owners acquired a depletable interest when they contributed the use of their land so as to enable the taxpayer, as lessee, to drill for and produce oil and gas from the offshore deposits and received, in exchange, the right to share in a stipulated portion of the taxpayer's profits from the oil and gas produced. Consequently, the courts below were wrong in concluding that the taxpayer (except for the royalties paid to the lessor, the State of California) possessed the entire depletable interest and was not required to exclude the net profit payments made to the upland owners from the base on which percentage depletion is calculated. That is, we contend that the taxpayer's "gross income from the property," on which percentage depletion is computed under Code Section 114 (b)(3) cannot include the amounts paid to the upland owners for the privilege of drilling through and using their property any more than it can include the amounts paid to the State of California for the privilege of producing oil and gas from the deposits.

1. Section 87 (a) of California State Lands Act of 1938 (Appendix, *infra*, pp. 46-47) provided that any lease for the extraction of oil and gas from tide and submerged lands was to contain a provision requiring that the wells be drilled only from filled lands or slant drilled from an upland or littoral drill site and that all machinery and equipment should be located only on filled lands, littoral lands, or uplands and that all operations should be conducted from such sites. Section 89 of the State Lands Act (Appendix, *infra*, p. 47) authorized the state's leasing authority to include a requirement that bidders for leases furnish satisfactory evidence of the ability to furnish all necessary sites and rights-of-way to conduct operations in this manner and to reject all bids which did not meet this requirement.

Pursuant to this statutory authority, the California State Lands Commission, during August, 1938, published a notice of intention to receive bids for the extraction of oil and gas from certain offshore deposits in Orange County, California. (Ex. 1-A, R. 21-24.) The notice required each bidder to furnish satisfactory evidence of the ability to furnish all necessary sites and rights-of-way (without cost or obligation to the state) by an endorsement by upland owners acknowledging that the bidder has been granted such sites and rights-of-way and by copies of instruments transferring such sites and easements from the upland owners to the bidder. (Ex. 1-A, R. 21-24.)

It is stipulated that there were no filled lands which were available or usable for the extraction

and exploitation of gas and oil from the area which was to be leased. (R. 8-9.) Consequently, in order to comply with the provisions of the State Lands Act and to qualify as a bidder, it was necessary for the taxpayer to obtain and to furnish satisfactory evidence that it had acquired the necessary sites and easements from the upland owners so that it could slant drill the wells through their property and locate its machinery and equipment for drilling and production on their property.

Before transmitting its bid, the taxpayer entered into an agreement on August 25, 1938, with the upland owners (including Huntington Beach Company) under which it acquired the necessary sites and easements to permit it to slant drill through their property so as to bottom the wells in the offshore deposits and to locate the necessary machinery and equipment on the surface of the upland owners' property. (Ex. 2-B.)[1] On the same day, the parties entered into another agreement detailing the manner in which the drilling and other operations were to be conducted. (Ex. 8-H, R. 49-58.)

When the taxpayer submitted its bid on August 30, 1938, there was transmitted with it the agreement by which the upland owners granted the necessary sites and rights-of-way and also a form of agreement for the state easement containing an en-

[1] This exhibit, constituting part of the record before this Court, is not produced in the printed record. It is reproduced as Exhibit 5 in the record in the *Huntington Beach* case, No. 287, present term, R. 18-21.

agreement by the upland owners acknowledging that the taxpayer had been granted the necessary sites and easements. (R. 7; Ex. 5-E, R. 24-49.)

Immediately following acceptance by the State of California of taxpayer's bid on September 26, 1938 (R. 8), the taxpayer and the upland owners entered into an agreement on September 27, 1938, which, among other things, provided that the taxpayer was to pay a stipulated percentage (a total of 24½ percent) of its "net profits" from operations under the state lease to each of the upland owners as consideration for the rights and privileges granted by the upland owners to the taxpayer under their prior agreement. (R. 9; Ex. 9-I, R. 59-74.)

2. Under the circumstances which existed when the taxpayer obtained the right to drill for and produce oil from the offshore deposits, it is plain that neither the taxpayer nor any other bidder could have qualified except by obtaining the use of the property belonging to the upland owners. No filled lands being available (R. 8), the requirements of state law and the terms on which the bids were let could only be met by acquisition of the right to slant drill through the the property of the upland owners and to conduct drilling and production operations on the surface of their property. In the situation, there could have been no production except with the consent of the upland owners.

Having contributed part of the property which was necessary for the extraction of the oil deposits

and having received, in turn, a right to share in the profits derived from the production and sale of the oil, the upland owners made a capital investment and acquired a depletable interest in the mineral property. The upland owners will be compensated for the valuable property rights which they granted to the lessee only for as long as production takes place from the wells. As the oil is extracted and the deposit is exhausted, the upland owners' possibility of profit on their contributed investment will similarly be exhausted and will ultimately come to an end. In the words of the *Burton-Sutton* opinion, it is the upland owners' (328 U.S. 25, 34-35) "'possibility of profit' from the use of [their] rights over production, 'dependent solely upon the extraction and sale of the oil', which marks an economic interest in the oil."

3. The present case, it is true, differs from prior cases decided by this Court in that the upland owners did not, themselves, have the right to drill for and produce oil from the deposits. However, the principles applied by this Court compel the conclusion that this did not prevent the upland owners from having acquired a depletable interest.

In *Palmer* v. *Bender*, 287 U.S. 551, the lessees of oil and gas leases transferred the leases for considerations, part of which were payable in the form of royalties out of future production. Although the Government argued that the leases had been assigned, with no reversionary interest being retained by the transferors, so that the transaction should be treated as a sale with no depletable in-

terest being retained by the transferors, and although the taxpayer contended that the transfers should be regarded as subleases under local law with some reversionary interest remaining in the transferors, this Court refused to decide which version was correct or to rest its decision on such a ground, saying (p. 555): "We do not think the distinction material." Noting (pp. 556-557) that the statute does not confine the depletion allowance to those who are lessors and that, in requiring that the allowance be equitably apportioned between lessors and lessees, the statute (p. 557) "presupposes that the deductions may be allowed in other cases," it was said that the ultimate question must be resolved by looking (p. 555) "to the particular interests secured to the two partnerships [the transferors] by the instruments in question to ascertain whether they come within the statutory provision." Because part of the consideration passing to the transferors was to be paid out of oil royalties, i.e., out of future production, it was held that, for tax purposes, the transactions were not sales and that the transferors retained a depletable interest. The Court said (p. 558): "When the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil in place, identical with that of a lessor."

The teaching of *Palmer* v. *Bender* is plain. A taxpayer may retain a depletable interest even though he has parted with all legal interest in the

deposits and no longer has any present or future right to exploit the underlying minerals in place. If he has a continuing interest in the production of the oil and gas (evidenced by the right to receive royalties) and must look only to that source[6] for a return of his capital investment, a taxpayer has a depletable interest.

Thomas v. Perkins, 301 U. S. 655, and *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25, are other instances where the transfer of exploitation rights in the oil deposits was considered immaterial to the existence of a depletable interest. In both cases there had been assignments of the leases: in the *Perkins* case the assignor was to receive a stipulated sum payable only out of a fractional part of the oil produced and in the *Burton-Sutton* case the assignor was to receive a fractional part of the operator's net profits. As was true of *Palmer v. Bender*, *supra*, the question whether the assignors had retained any legal interest in or the right to exploit the deposits was considered inconsequential. Instead, the provisions for payment out of oil produced in *Perkins* and out of profits from oil produced in *Burton-Sutton* were held to be determinative that the transferors had an economic interest in the minerals and were receiving depletable income from their production.

Under the rationale of the *Bender*, *Perkins* and *Burton-Sutton* cases, the fact that the upland owners in the present case do not possess any legal

[6] Compare *Anderson v. Helvering*, 310 U. S. 404.

interest or rights of exploitation with respect to the oil deposits should in like manner be considered immaterial. The contribution which the upland owners made by permitting their land to be used for the drilling of the wells and the production of oil and gas was, in a very practical sense, as necessary in the particular circumstances of this case to the exploitation of the mineral deposits as was the contributions made in the *Bender*, *Perkins*, and *Burton-Sutton* cases when those taxpayers transferred their leases to the operators of the wells. Since the right to obtain payment out of future production was the only critical relationship which the assignors possessed with respect to the oil deposits in the above cited cases, and which was held to represent the retention of a depletable interest, the acquisition by the upland owners of a similar right in the present case must also mark the acquisition of a depletable interest. It need scarcely be added that the *Burton-Sutton* case and *Kirby Petroleum Co.* v. *Commissioner*, 326 U. S. 599, demonstrate that the upland owners' right to share in the taxpayer's net profits is no less depletable than the right to receive a share of gross production in the *Bender* case, or the right to receive oil payments in the *Perkins* case. In the language of the *Bender* case, since the upland owners contributed their property to enable the production of oil and gas to take place, and became entitled to share in the net profits from such production (p. 558):

> the oil in the ground was a reservoir of capital investment of the several parties, all of whom

> * * * were entitled to share in the oil produced. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests. * * * Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case.

We believe that the example given by the Court of Claims in the *Huntington Beach* case (No. 287, R. 60) is apt. It posed the hypothetical situation where the owner of land had given an easement to a golf club to use the surface of the land and later, after the discovery of oil in the vicinity, granted the mineral rights to another party, reserving a royalty. Needing the assent of the party possessing the easement to the surface of the land in order to drill for the oil, the party with the mineral rights obtained the necessary rights from the golf club in exchange for a percentage of its net profits from production of the minerals. The Court of Claims observed, correctly we believe (No. 287, R. 60):

> The golf club never owned the oil in place, nor any right to produce it. What it owned was an interest in the surface of the land of such a nature that no one could recover the oil by usual and economical methods without first obtaining from it the right to use the surface

for drilling. The discovery of oil in the neighborhood increased the value of its interest in the surface. Under the royalty agreement which it made with the operator, its income from its interest in the land would rise and fall with oil production. As oil was taken out, its prospects for future income would diminish, because of the depletion of the source of its income.

It would seem that, by any realistic standard, the golf club must be said to have an economic interest in the production of the oil. Its physical and legal relation to the situs of the oil puts it into a position to prevent the production of the oil, or permit its production on prescribed terms. That power gave value to its interest in the land. That value was depleted as the oil was taken out.

The upland owners in the present case, as the Court of Claims stated (*id.*) are in the same position as the golf club in the hypothetical case, except that here, where it was necessary to drill on a slant, it was the property of adjoining land owners which was necessary to enable production to take place, while in the supposititous case, where vertical drilling was possible, it was the golf club's rights in the surface land above the oil which were necessary to enable production to take place. The Court of Claims was correct, we believe, when it said (*id.*) "the fact that the drilling was done

slantwise instead of vertically, is surely immaterial."

4. The reasons given by the Tax Court (R. 102-103) and relied on by the Court of Appeals (R. 125-129) for the decision below to the effect that, except for the royalties paid to the State of California, the entire depletable interest was in the taxpayer and that none was possessed by the upland owners, will not withstand analysis. Those reasons may be summarized as follows:

(a) Except for the royalty interest retained by the State of California, the lease granted to the taxpayer, and only to the taxpayer, exclusive rights to produce the oil from the deposits (R. 102);

(b) the upland owners were never owners or lessees of the property and could not have produced oil from the deposits (R. 103);

(c) the agreement between the taxpayer and the upland owners expressly provided that the latter were not to be considered as acquiring any right, title or interest in the oil and the parties expressly stated that they did not intend to create a partnership (R. 103);

"Other analagous situations suggest themselves. See, for example, the discussion of various tax problems in Compensatory or Substitute Royalty, IV Oil and Gas Tax Quarterly 11-23 (1954); under an assumed state of facts where the lessee has separate leases from adjoining landowners A and B. Wells drilled on A's property are so situated that the lessee would be required under B's lease to drill offset wells on B's property. However, to avoid drilling the offset wells, the lessee agrees to pay B an overriding royalty measured by the production from A's wells. The author suggests (pp. 13, 23) that B has a depletable interest.

California might see fit to change its policy
drilling in the submerged coastal lands."

the taxpayer, as lessee, had the exclusive
drill for and produce oil from the deposits,
upland owners did not have this right and
y did not have technical title to the oil in
not furnish, for the many reasons discussed
(pp. 18-20, 25-30 *supra*), a solid basis for the
that the upland owners lacked any depleti-
terest. Consequently, the Tax Court's
summarized in (a), (b) and (c) above, are
sive. If the statement in reason (d)
upland owners did not have any (R. 103)
investment" in the oil in place be read as
reiment that a monetary investment is
the courts below relied on an erroneous
le. See *Burton-Sutton Oil Co. v. Com-
r*, 328 U.S. 25, 34, and p. 16 *supra*. At
s, by dedicating valuable rights in and to
roperty, the upland owners did, in fact,
n investment in the taxpayer's wells. If,
r, this statement is read merely as an an-
ment of the ultimate legal conclusion that
nd owners lacked a depletable interest, it
thing to the reasoning of the courts below.
inal reason relied on in (e) above is that

on to pay a percentage of its net profits to the land owners.

We believe, however, that the ultimate decision ould rest on the rights of the parties under the cumstances that actually exist and not on specu- ion regarding possible changes that might take ace at some future date. The fact is that, under isting provisions of the state law and under the isting terms of the leasing agreement, the tax- yer had no alternative except to slant drill rough the property of the upland owners. In rmitting their property to be used for this pur- se, the upland owners gave up valuable rights d were able to exact a price, consisting of a share the operator's net profits. And, during the en- e period while production has been taking place, e upland owners have shared in it by receiving ½ per cent of the taxpayer's profits from the oil oduced. During the past seventeen years, the ate of California has not enacted any changes ich would permit the taxpayer to replace the esent wells by new, vertically drilled wells to alter its agreements with the upland owners.[7]

Statutes of California (1945), c. 1393, Sec. 1, p. 2597 (Sec. 3, Public Resources Code, Deering's California Codes 954)), amended the statute to permit drilling—

> from a drill site located upon any pier heretofore constructed for drilling purposes and available for such

, aside from the obvious impossibility of pre-
ing whether there will ever be any such change
he state's legislative policy, it is equally impos-
to predict whether the taxpayer, if it were
mitted to do so, would find it economical or
ible to incur the expense of drilling new
ical wells to replace the exisiting wells.
he upland owners have a real, present interest
roduction which is neither ephemeral nor tran-
ry. If that interest otherwise qualifies as a de-
able interest, it should not be deprived of that
us because of some incalculable possibility that
situation may be altered in the future by cir-
stances which are beyond the control of the par-

We believe, for the reasons stated above, that
ecision holding that the upland owners possess
pletable interest can rest on the narrow ground
under the unique facts of this case, they
ribuged property rights which were essential to
production of the oil and received, in return,
nterest in production measured by the opera-
s net profits from that production. The de-
n of the Court of Claims in the *Huntington*
rk case (No. 287, this term) was based on a
lar appraisal of the situation. Under such a

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drilling upon any tide or submerged lands described in
any valid existing lease heretofore issued * * *, if in the
udgment of the commission such drilling will be in the
ublic interest.

is amendment did not change the situation with respect
e wells involved in this case and indicates no tendency
rmit new piers to be erected for drilling purposes.

w of the case, the factual circumstances here are
tinguishable from other cases where this Court
s held that an interest in the operator's net prof-
was not a depletable interest.

Thus, in *Helvering v. O'Donnell*, 303 U.S. 370, the
payer owned one-third of the stock in A com-
ny which held certain oil and gas leases. He sold
stock to B company which agreed to acquire the
properties of A company and to pay the tax-
yer one-third of the net profits from the opera-
n of these leases.

t was held that the taxpayer did not have a de-
table interest with respect to the net profit pay-
nts which he received. The opinion pointed out
t, as a mere shareholder of the A company, the
payer did not have a depletable interest in its
operty, and concluded that he did not acquire one
en he transferred his shares of stock in exchange
the right to receive one-third of B company's
profits derived from operating the same prop-
y.

Since the taxpayer in *O'Donnell* did not contrib-
any rights which were essential to enable pro-
tion of the minerals to take place, this an im-
tant ground of distinction which sets *O'Don-*
apart from the present case as well as from
Kirby (326 U.S. 599) and *Burton-Sutton* (328
S. 25) cases. As the Court said in *Burton-*
ton with reference to the *O'Donnell* case (fn.
p. 35): "A participation in net profits dis-
ociated from an economic interest does not en-
a recipient of such profits to benefit from de-

on." In the present case, because of their pe-
r relationship to the oil and their unique con-
tion toward its production, the upland owners'
cipation in the operator's net profits is not
ssociated from an economic interest."

Helvering v. *Elbe Oil Land Co.*, 303 U.S. 372,
axpayer, the owner of certain oil property, had
ferred it for a stated consideration of $2,000,-
part of it payable at the time of the execution
e agreement, and the remainder payable in in-
nents in succeeding years if the transferee
d elect not to abandon the transaction. The
ayer, in addition, was to be entitled to receive
hird of the net profits which the transferee
t earn after having been fully reimbursed for
xpenditures in the acquisition, development,
peration of the properties.

e issue in the *Elbe* case was whether the trans-
was entitled to depletion on the installments
e lump sum payments received (there appar-
having as yet been no net profits, as defined
e agreement). The Court held that the pay-
s represented the receipt of proceeds from the
f the property, saying (pp. 375-376)—

The aggregate sum of $2,000,000 was paid as
n agreed purchase price to which was to be
dded the one-third of the net profits payable
n the conditions specified. We are unable to
onclude that the provision for this additional
ayment qualified in any way the effect of the
ransaction as an absolute sale or was other

than a personal covenant of the Honolulu Company. See *Helvering* v. *O'Donnell*, *ante*, p. 370. In this view, neither the cash payments nor the agreement for a share of subsequent profits constituted an advance royalty, or a "bonus" in the nature of an advance royalty, within the decisions recognizing a right to the depletion allowance with respect to payments of that sort. Such payments are made to the recipient as a return upon his capital investment in the oil or gas in place. See *Burnet* v. *Harmel*, 287 U.S. 103, 111, 112; *Murphy Oil Co.* v. *Burnet*, 287 U.S. 299, 302. Payments of the purchase price which are received upon a sale of oil and gas properties are in a different category.

Since *Elbe* did not directly involve the depletable nature of the net profit payments, and in view of the subsequent decisions in the *Kirby* and *Burton-Sutton* cases, the decision in *Elbe* does not negate the existence of a depletable interest in the upland owners in this case.[8]

II

Alternatively, the Right of the Upland Owners to Receive a Percentage of the Taxpayer's Net Profits From Production Is, of Itself, A Depletable Interest

In the preceding portion of the brief, we have shown why, under the decisions of this Court, the

[8] In the *Burton-Sutton* case, the Court stated that the holding of *Elbe* (328 U.S. 25, 36) "should not be extended" to the facts presented in that case.

lar facts of this case require the conclusion
e upland owners are entitled to depletion.
vever, the Court should disagree, we urge
e decision be predicated on broader grounds,
, that it be held that the upland owners ac-
a depletable interest when they became en-
o share in the lessee's net profits derived from
oduction and sale of the minerals and that it
aterial how they acquired that interest. It
gnized that such a decision would require an
ion of what was decided in *Kirby Petroleum*
'ommissioner, 326 U.S. 599, and *Burton-Sut-*
Co. v. Commissioner, 328 U.S. 25. It would
ent, however, a logical application of the
ples applied in those cases and would make
workable rule which would furnish much
certainty to taxpayers and the Government

he context of the *Burton-Sutton* case, this
was required to go no farther than to hold
ne who formerly possessed the right to pro-
he minerals and who relinquished it in ex-

for an interest in the operator's net profits
ued to possess a depletable interest. It was
cessary to decide whether such an interest,
acquired by someone who is otherwise a
er to the oil, such as a purchaser for a cash
eration, would be a depletable interest. That
vill, however, be presented by this case if the
disagrees with our position under Point I.

That is, if the upland owners, despite the
bution of the use of their property are not in
me position as the transferors in the *Kirby*

nd *Burton-Sutton* cases, then it must be decided whether they would have been entitled to depletion they had purchased for a cash consideration, the ght to receive a portion of the taxpayer's net rofits.

1. When a lessor, who has retained a royalty in he form of the right to receive a percentage of production or of its proceeds, sells all or part of his retained interest, the purchaser has long been regarded as acquiring a proportionate, depletable interest. In I. T. 1894, VII-1 Cum. Bull. 186 (1924), was ruled that a purchaser of a royalty interest ay deduct an allowance for depletion. Again in .C.M. 22730, 1941-1 Cum. Bull. 214, 224, it was uled that one who purchases an oil payment from he lessee (i.e., the right to receive a stipulated sum ut of a fractional part of the oil produced) acuires a depletable interest. Indeed, it is not uncommon for lessors or lessees to sell fractional arts of their right to share in gross production, nd it has long been the administrative practice recognize the right of the purchasers of such ractional royalty interests to take depletion deuctions.

The question naturally arises whether a right to hare in the operator's net profits should stand on he same footing as the right to share in gross production, with each being depletable no matter how is acquired or from whom it is obtained. We beeve that a uniform, workable rule requires an ffirmative answer. For example, since the assignor in the *Burton-Sutton* situation is entitled

lepletion when his only relationship to the oil
lace consists of the right to share in the opera-
's net profits, what should the tax situation be
e sells that right to another? Should the pur-
ser be denied depletion on the theory that his
erest is (328 U.S. 25, fn. 14, p. 35) "disas-
iated from an economic interest"? If so, would
portion of the depletion allowance previously
nted to the assignor now be granted to the op-
tor, who is a stranger to the transfer, or would
s portion of the depletion allowance now be
ied to all parties, contrary to the plain require-
nts of the statute?

We submit that a better rule would recognize the
letion rights not only of the party who has re-
ved an interest in the operator's net profits but
o of any successor to that interest, whether he
uired it by purchase, gift or inheritance. Such
ule would be in harmony with the principle
t depletable income depends upon the relation-
p of the income recipient to the production of
minerals. By the same token, a taxpayer who
sesses the right to share in net profits and who
uires it from the operator of the wells rather
n from the lessor or assignor of the lease, should
o be considered to have acquired a depletable
erest. Again, it should make no difference
ether the acquisition has been by purchase, gift
inheritance. In short, a taxpayer who has the
ht to share in net profits from production should
nd in the same taxable position as the taxpayer

who possesses a fractional right to share in gross production.

Under such a logical extension of the *Kirby* and *Burton-Sutton* decisions it should be held that the upland owners acquired a depletable interest, just as though they had purchased, for cash, the right to receive 24½ percent of the taxpayer's net profits from the production of oil and gas from these leases.[9]

2. If the broad rule for which we here contend is adopted, we recognize that it would be difficult to reconcile the result with the decisions in *Helvering* v. *O'Donnell*, 303 U.S. 370, and *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372.[10]

The factual differences between *Burton-Sutton* and *O'Donnell* do not, we submit, reflect significant points of distinction. It is true that prior to acquiring an interest in the net profits from production, the assignor in *Burton-Sutton* had a depletable interest, while the taxpayer in *O'Donnell* did not. The existence of a depletable interest, how-

[9] Where, as in this case, the right to share in net profits is obtained, not for cash, but in exchange for property rights, other tax problems may arise with respect to the transaction of exchange. Such problems are not in issue here and need not be discussed.

[10] Commentators have already expressed the difficulty of reconciling the *O'Donnell* and *Elbe* cases with the *Kirby* and *Burton-Sutton* decisions. See 4 Mertens, Law of Federal Income Taxation (1954), Sec. 24.21, c. 24, p. 61; Baker, The Nature of Depletable Income, 7 Tax L. Rev. 267, 281-284 (1951-1952); Modesitt, Capital Gains on Oil and Gas Transactions, 27 Rocky Mt. L. Rev. 39, 44-49, 53 (1954); Levy and Simonds, The Depletion of Net Profit Payments, 25 Taxes, The Tax Magazine 615, 620 (1947).

ver, should be tested in accordance with the present rights of the parties and not in accordance with their prior rights when they may have occupied a different economic relationship to the mineral deposits. When the taxpayer in *O'Donnell* acquired the right to a share of net profits he then possessed the same interest, the identical (326 U.S. 399, 404, and 328 U.S. 25, 34-35) "possibility of profit" which was "dependent solely upon the extraction and sale of the oil" as was possessed by the assignor in *Burton-Sutton*. We submit that a harmonious development of the law requires the conclusion that *Helvering* v. *O'Donnell* should be overruled.[11]

Similar difficulties exist in attempting to reconcile *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372, with the *Kirby* and *Burton-Sutton* decisions.[12]

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[11] By transferring shares of stock in exchange for the right to receive a percentage of the operator's net profits, the taxpayer in *O'Donnell* may have sustained taxable gain or loss measured by the difference between the basis of the shares of stock transferred and the fair market value of the interest which he acquired. See fn. 10, *supra*, p. 41.

[12] The *Burton-Sutton* opinion relied on two factors to distinguish *Elbe*. The first (p. 36) was that the instrument of transfer in *Elbe* provided that after the transfer the transferor (except in the case of an abandonment by the transferee) should have no interest in the properties. This, however, should not have been considered determinative for the tax results in the field of depletion have never turned on the descriptive terminology employed by the parties or "the formalities of the conveyancer's art." *Anderson* v. *Helvering*, 310 U.S. 404, 411. See also pp. 18-19, *supra*.

The second distinction mentioned is that the grantor in *Burton-Sutton* (pp. 36-37) had the right to buy the oil produced on stated terms, a right not existing in *Elbe*. But such right, even if it was one to purchase on favorable terms, would not represent a depletable interest in the minerals in

True, in *Elbe* the issue was whether the installment payments received represented the proceeds of a sale rather than depletable income from the mineral property. There having been no net profit payments during the taxable periods involved, there was no immediate issue concerning their status. However, the decision would seem to turn on the Court's conclusion that, although reserving the right to receive one-third of the operator's profits (computed after the operator had been reimbursed for all costs of acquisition, development and operation), the taxpayer must be considered as (p. 376) "retaining no investment" in the property. The taxpayer's reservation of the right to receive one-third of the operator's net profits was not considered as having (p. 375) "qualified, in any way the effect of the transaction as an absolute sale * * *."

We believe, however, that it would be consonant with the *Kirby* and *Burton-Sutton* cases to consider that the reservation in *Elbe* of an interest in the operator's net profits was the reservation of an economic, depletable interest in the mineral properties. The receipt of a cash payment is not regarded as representing sale proceeds where the recipient reserves the right to receive a fractional part of gross production throughout the life of the lease; instead, the cash payment or bonus in these circumstances is treated as an advance royalty

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place (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362) and could not make *Burton-Sutton* a stronger case for depletion than *Elbe*.

hich is depletable.[13] The receipt of a cash pay-ent should similarly not be regarded as sale pro-eds where the right is reserved to receive a frac-onal part of the net profits derived from produc-on. Here, too, the cash payment should be con-dered as a bonus or advance royalty. Accord-gly, we believe that *Helvering* v. *Elbe Oil Land o.* should also be regarded as no longer authori-tative.

CONCLUSION

The decision of the Court of Appeals should be eversed.

Respectfully submitted,

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OVEMBER, 1955.

[13] *Herring* v. *Commissioner*, 293 U.S. 322; *Palmer* v. *Bender*, 87 U.S. 551; *Bankers Coal Co.* v. *Burnet*, 287 U.S. 308; *Murphy Oil Co.* v. *Burnet*, 287 U.S. 299; *Burnet* v. *Harmel*, 287 S. 103.

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the

allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C. 1952 ed., Sec. 114.)

lifornia State Lands Act of 1938, Statutes of fornia (Extra Session 1938), c. 5:

Sec. 87. The commission shall prepare a form of lease which shall contain, in addition to other provisions deemed desirable and necessary by the commission, appropriate provisions contained in this act and the following:

(a) Each well drilled pursuant to the terms of such lease shall be drilled only upon filled lands or shall be slant drilled from an upland or littoral drill site to and into the subsurface of the tide or submerged lands covered by the lease. The derricks, machinery, and any and all other surface structures, equipment, and appliances shall be located only upon filled

all surface operations shall be conducted therefrom.

Sec. 89. In any notice of intention to lease tide or submerged lands, the commission may include a requirement that each prospective bidder, as a condition precedent to the consideration of his bid and in addition to the other qualifications required by this act, shall present evidence satisfactory to the commission of his present ability to furnish all necessary sites and rights of way for all operations contemplated under the provisions of the proposed lease. In such event the commission shall reject the bids of all bidders who fail to qualify as provided by this section.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(m)-1. *Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements.*—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an

economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possesed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

(b) A "mineral property" is the mineral deposit, the development and plant necesary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(c) The term "mineral deposit" refers to

posit is that proportion of the total cost of t
mineral property which the value of the d
posit bears to the value of the property at t
time of its purchase.

* * * * *

(i) "The property," as used in section 1
(b) (2), (3), and (4) and sections 29.23(m)
to 29.23(m)-19, inclusive, means the intere
owned by the taxpayer in any mineral pro
erty. * * *

Section 19.23(m)-1 of Treasury Regulation
103, promulgated under the Internal Revenue Co
of 1939, applicable to the years 1939 through 194
is substantially the same as Section 29.23(m)-1
Treasury Regulations 111.

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IN THE

Supreme Court of the United States

October Term, 1955

No. 286

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

SOUTHWEST EXPLORATION COMPANY, a corporation,

Respondent.

Brief for Respondent in Opposition to Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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Brief for Respondent in Opposition to Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Opinions Below.

Findings of Fact and Opinion of the Tax Court [R. 75-104] are reported in 18 T. C. 961. The Opinion of the Court of Appeals is reported at 220 F. 2d 58, and is set forth in Appendix B in the Petition for Writ of Certiorari.

Jurisdiction.

The jurisdictional requisites are adequately set forth in the Petition.

Question Presented.

In order to develop the tideland oil resources of the State of California in a manner which would not permit the beaches to be despoiled, the State Lands Act of California (Stats. Ex. 1938, Chap. 5.), required that all drill-

ing and other operations in connection with extracting oil from submerged State lands be done from filled land or upland drill sites. The same Act permitted the State to condemn uplands or other facilities needed for oil development or to lease them and make them available to its tideland lessees. In the case at bar the respondent, Southwest Exploration Company, State lessee, could physicially have developed the lease without use of the uplands, but because of the state law it obtained use of the uplands for slant drilling sites, and agreed to pay the upland owners, as rent, an amount equal to 24½% of its net income from the State lease. If respondent had a final over-all loss on the operation of the lease, the upland owners were still entitled to keep the rent they had received. The agreement with the upland owners provided that they were to have no interest in the State lease or the State mineral resource, and that the rights they extended to respondent added nothing to the exclusive lease given respondent by the State. Should respondent fail to pay the upland owners the rent for the use of their rights-of-way, the upland owners' only recourse was a claim for damages as they could not cancel the rights-of-way. Respondent had the sole right to enter upon the State lands, drill and produce oil. It could modify the State lease, or abandon it, without the consent of the upland owners. The upland owners were already entitled to depletion deductions on royalties received from a lessee who was developing their own oil resources by vertical wells, and respondent did not extract oil or gas from beneath the uplands.

Was respondent required to exclude from its gross income, on which it could take depletion deductions, the amounts which it paid to the owners of the uplands as rental for the use of their non-mineral property?

Statutes and Regulations Involved.

In addition to the Statutes and Regulations set forth in the Appendix of the Petition (pp. 17-21 incl.), other Statutes are involved in this proceeding as shown in Appendix A, *infra* pages.

Statement.

In addition to the facts stated in pages 3 to 9, inclusive, of the Petition, respondent deems the additional statement of facts to be material.

Prior to 1938 the State of California permitted State lessees and oil operators to develop tideland oil deposits from piers, islands and barges. [Rep. Tr. p. 30.]

This practice resulted in waste petroleum products interfering with fishing and bathing along the beaches of Southern California, and in 1938 the California Legislature passed the State Lands Act of 1938, under which the State Lands Commission was appointed, with power to lease and develop the tidelands in such manner as to prevent the oil operations from despoiling the beaches. (California Public Resources Code, Section 6828 and Section 6829.)

It was physically possible for respondent to have developed its tideland lease from piers, filled lands and barges and without the use of the uplands. [Rep. Tr. p. 30.] It could have made a drilling island which would have constituted "filled lands." (*Monterey Oil Company v. City Court of City of Seal Beach*, 120 Cal. App. 2d, 31.) If the State law were changed, respondent could even now physically develop its State Easement No. 392 from filled lands, barges or piers. [Rep. Tr. p. 34.]

Beginning in 1923, Standard Oil Company of California drilled vertical wells on the uplands involved in this pro-

ceeding, and has produced oil from said uplands ever since. The upland owners were entitled to depletion deductions on their income from said oil production. [Rep. Tr. pp. 29, 30; Joint Exs. 6-F and 7-G.]

All the wells drilled by respondent had their tops on the uplands and their bottoms under the ocean more than 200 feet away from the high tide as required by the State lease and the agreements with the upland owners. [Stip., Pars. 4, 14, 18; R. pp. 8-9, 14-15.] Respondent has not taken any oil from beneath the uplands. [Stip., Par. 8; R. pp. 8, 14; Rep. Tr. p. 28.]

The agreement for Easement No. 392 [Ex. 5-E, Par. 2-N] prohibits the lessee from assigning or subletting the lease in whole or in part, without the written consent of the Commission. Exhibit No. 9-I (the agreement by which the respondent agreed to pay, as rental, an amount equal to 24½% of its net profits to the upland owners) was not among the agreements sent to the State Lands Commission for written consent.

If respondent failed to pay the upland owners the rental due them under the agreement of September 27, 1938 [Ex. 9-I], their only recourse was to sue respondent for damages and they could not rescind the rights-of-way which entitled the respondent to drill its wells from their uplands. [Ex. 9-I, Par. 13; R. p. 70.] Furthermore, should respondent operate the State lease at a final overall loss, the upland owners are entitled to keep the rental payments they have received out of current apparent profits. [Ex. 9-I, Par. 14; R. pp. 70-71.] The upland owners' rights to receive rent was a personal obligation only and might have been payable out of respondent's capital, and was not solely payable out of net profits from the oil operations.

ARGUMENT.

An investment in a mineral resource and the right to enter, drill and extract the resource constitute a depletable interest. Such an interest belongs to a landowner. He does not entirely dispose of that interest by arranging for a lessee to carry on drilling and extracting operations and paying a royalty therefor. The lessor retains a reversionary interest in the property and thus controls the operations of the lessee by having the right to cancel the lease in the event of the improper conduct of the lessee. (*Kirby Petroleum Co. v. Com.*, 326 U. S. 599.)

The lessee has a depletable interest by virtue of his right to enter, drill and extract and his investment in those rights and operations. (*Lynch v. Alworth-Stephens Co.*, 267 U. S. 364.)

The lessee can give another the right to enter, drill and extract, and retain some control thereof through the contract of assignment and through retention of a reversionary interest in the lease. The lessee retains a depletable interest and can take depletion deductions on any overriding royalty or share of net profits or other portions of the gross or net income from the property which he retains. (*Palmer v. Bender*, 287 U. S. 551.) The assignee acquires a depletable interest by virtue of his right to enter, drill and extract and enjoy some of the income. (*Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25.)

If a landowner or a lessee entirely assigns or sells his interest, retaining no reversionary interest in the property and no power of management over the property or its operations, he has given up or lost his depletable interest, even though as part of the sale price he is to receive some of the gross or net income from the property. This is

regarded as a mere personal obligation of the assignee and not a retention of an interest in the oil in place by the assignor or seller. (*Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372; *Anderson v. Helvering*, 310 U. S. 404.)

In other words, one has to obtain the whole or a fractional interest in the right to enter, drill and extract, and retain an interest therein before he can have a depletable interest.

Unless a person has acquired and retained some control over the right to enter, drill and extract he does not have a depletable interest even though he has, through some kind of an arrangement with such a holder of a depletable interest, a right to receive money, which right may decline in value as the mineral resource is extracted and money is received by such holder. He has a mere economic advantage.

Helvering v. O'Donnell, 303 U. S. 370;

Anderson v. Helvering, 310 U. S. 404;

Helvering v. Elbe Oil Land Development Company, 303 U. S. 372.

These principles are all clearly set out in Regulations 111, Section 29.23(m)(1), in effect for the years involved in this case.

The respondent, as lessee from the State, had the sole right to enter, drill and extract mineral resources from the State tideland lease, and respondent did not assign any interest therein to the upland owners, and the upland owners did not add anything to such rights respondent received from the State. The upland owners have specifically agreed to this in their contracts with the respondent.

Furthermore, the upland owners have leased their mineral property to the Standard Oil Company which has drilled vertical wells therein which have been depleting the property since 1928. The upland owners undoubtedly receive royalties from the Standard Oil Company and are clearly entitled to depletion deductions thereon.

The upland owners merely rented to the respondent certain rights in the surface of their land and the right to drill through their land out into the ocean but did not rent to respondent any portions of their mineral resources.

The facts show that respondent did not produce any oil from the uplands but drilled all its wells at least 200 feet from shore and produced only from the tidelands.

Consequently, the mineral resources of the upland owners are not being depleted by respondent and they are suffering no depletion from respondent's operations. Whatever rights they have to the surface and subsurface of the land, they will still have when respondent has terminated with the State lease and the State oil reserve is entirely depleted. The upland owners' land will be as valuable as it was before, so far as the mineral resources under such land are concerned.

All these matters the Tax Court and the Circuit Court of Appeals clearly understood and they properly applied the Regulations and the Supreme Court cases to this situation. They held that the upland owners were strangers to the State lease, had no right to produce, did not produce from the tidelands and that respondent did not deplete the upland owners' property.

The decision of the Circuit Court of Appeals in the instant case is clearly correct and is not in conflict with

the decision in the Court of Claims in the Huntington Beach case. In the Huntington Beach case the Government did not clearly present the facts showing that respondent did not extract oil from the upland owners' land, or that the upland owners were already receiving depletion deductions on the royalties they received from their own lessee from vertical wells drilled on their land, and did not otherwise show the true and correct factual situation. Consequently, the Government in the Court of Claims case did not fully or strongly present to the Court of Claims the respondent's position in this depletion question.

Therefore, the Court of Claims decision is not in conflict with the decision in the instant case as the two decisions are based on different facts. If the Court of Claims understood or ignored the pertinent facts, then its decision clearly conflicts with the Regulations and Supreme Court cases, and its erroneous decision was induced by the inadequacy in the presentation of the Government.

The confusion can easily be cleared up by denying the Writ of Certiorari in the instant case and granting it in the Huntington Beach case and summarily reversing the decision of the Court of Claims in that case. Such action would indicate the true state of the law on depletable interests.

The Government's confusion arises from the fact that it has followed certain general language of this Court in depletion cases, as distinguished from following the actual holdings of the Court to the effect that depletion was allowable only when the taxpayer acquired a right to enter, drill and extract, or having had that right, retained a reversionary interest therein.

The issue presented in the case at bar is unique because of the State law involved and the provisions of the particular contracts and is not likely to be found again in any other situation.

This Court in many cases has clearly established principles governing the depletion deduction and further enunciation of these principles by this Court is not needed.

Even the Commissioner's own Regulations clearly follow the Supreme Court decisions and correctly enunciate the principles applicable to the depletion question. The Commissioner appears no longer to understand these regulations.

The Huntington Beach Company should not be permitted to agree that it has no interest in the tideland lease or deposit and then later attempt to repudiate that agreement by claiming an interest in said lease in an income tax case by seeking a depletion deduction on the rent it received for the use of the surface of its property, a non-mineral property. In *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372, this Court observed that the construction put upon the contract by the parties was important and in the case at bar whatever doubt there ever could have been was put to rest by the contract of the parties themselves that the upland owners had no interest in the tideland lease or mineral reserve. It was further agreed in their contracts that the rights they granted to respondent did not add to the rights which respondent received directly from the State, namely, the sole right to enter, drill and extract oil and gas and retain all the income therefrom except the royalty payable to the state.

I.

The Decision Below Is Clearly Correct.

Respondent, as the lessee under the agreement with the ate, has the exclusive right to enter, drill and extract e oil from the tidelands. This is clearly a depletable terest. (*Lynch v. Alworth-Stephens Company*, 267 U. 364.) As lessee, respondent is entitled to take deple- on deductions on all the income from the property, ex- pt royalties paid to others having depletable interests in e mineral in place (*Helvering v. Twin Bell Oil Syndi- te*, 293 U. S. 312.)

Respondent could physically have developed its State ase from islands, filled lands, barges or piers. The Cali- rnia regulatory law required that it operate in such man- er so as not to despoil the beaches and hence, under the rcumstances of this case, required respondent to drill om the uplands.

In making arrangements for the use of the non-mineral ortion of the uplands necessary for the tops of its wells nd its oil derricks, etc. respondent agreed to pay, as rent, n amount equal to 24½% of its net income from the tate lease. In such agreement, however, it was specifi- lly provided that the arrangement with the upland own- rs did not add anything to respondent's lease from the tate, and did not assign to the upland owners any interest n such lease or in the mineral resource, and that the up- nd owners and respondent did not become partners. espondent retained the sole right to enter, drill and xtract, the sole right of management of the lease, the ight to modify or abandon the lease without the consent f the upland owners. The arrangements also provided hat in the event respondent failed to pay the rent to the pland owners the upland owners could not cancel their

right-of-way granted to respondent but could only sue respondent for damages. Finally the upland owners were entitled to keep their rental payments even though respondent operated the State lease at a final over-all loss. These provisions show that the upland owners' rights were merely personal covenants and not interests in the State lease or property.

The upland owners did not have any affirmative rights or control over production of oil from the tideland lease. They had an interim right to deny the respondent the use of their uplands—but not an absolute right. If the upland owners had been too unreasonable in their demands, the State could have condemned a right of way, or could have condemned their lands and turned over to the respondent the right to use the uplands. In any event, the upland owners did not have the right to enter, drill or extract oil from the State lease and hence had no depletable interest.

The upland owners merely rented some of their surface rights and the rights to penetrate their soil, but did not rent out to the respondent any of their oil resources. Respondent had no right to take any oil underlying the uplands and did not do so. The upland owners had already leased their mineral resources to the Standard Oil Company and were entitled to royalties and depletion deductions thereon. They can hardly expect to get two depletion deductions from the one piece of land or from one mineral resource.

Respondent clearly did not extract the oil resources of the upland owners, and the oil resources of the upland owners were not reduced or depleted in any manner by respondent's use of the surface or subsurface of the upland owners.

The upland owners were strangers to the lease and received an economic advantage from respondent who was the owner of an economic interest in the State's oil resources.

Under these circumstances, the Regulations and the Supreme Court cases clearly show that respondent only has the sole depletable interest in the State tideland lease, aside from such an interest in the State itself.

In 1933 in *Palmer v. Bender*, 287 U. S. 551, this Court decided its first case involving depletable interests in oil and gas wells. The Court, in that case, extended the depletion deduction to sublessors of oil and gas property.

The sublessors in that case retained control over the production of the property by retaining reversionary interests in the properties in the event the assignees did not properly operate the properties or wished to abandon them.

There were three assignors in the case of *Palmer v. Bender, supra*. One of them became a partner of the assignee and, of course, received depletion deductions because, as a partner, he was getting his share of the oil. In the second instance, while the assignment appeared to be absolute, the assignor received back a letter to the effect that should the assignee elect to surrender the lease it would be reassigned to the assignor. In the third situation there was no express provision that the lease would revert to the assignor but the District Court, in 49 Fed. 2d 316, page 324, clearly said that under Louisiana law, an assignment with a retention of some rights to royalties amounted to a sublease with the right in the assignor to a reversion in the lease in the event it was not properly carried out. The Government claimed that the agreements constituted sales in each case and that the taxpayer did not retain any depletable interests.

In the three situations where the agreements amounted to subleases, either by the terms of an agreement or by Louisiana law, this Court held that the taxpayer had retained a depletable interest under each document and had not entirely parted with his depletable interest. Then this Court used some language to the effect that it did not make any difference whether these instruments constituted assignments or subleases. (287 U. S. 555.) This was true in that case as, under Louisiana law, in the one case, and the letter agreement in the other, an apparent assignment amounted to a sublease.

This general language has caused confusion because the Commissioner and some courts have relied on this general language, instead of relying on the actual holding that where the lessees retained reversionary interests in the leases, they retained depletable interests.

This Court subsquently in *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372, held that it made a great deal of difference whether the instrument constituted an assignment (sale) or a sublease.

In the latter case the taxpayer, as a lessee, had had a depletable interest but had entirely parted with it in a sale of the property. A part of the sale price was a portion of the net profits from the operation of the property in the hands of the transferee. The parties had agreed that it was their intention that the full ownership, possession and control of all the property should become vested in the buyer and that the seller, Elbe, should have no further interest in said property. The Court said that the provision for the additional payment out of a part of the net profits did not qualify, in any way, the effect of the transaction as an absolute sale. The Court said that the agreement to pay a portion of the net profits to Elbe was a

personal covenant; that Elbe no longer had any capital investment in the property (though it had not yet received the entire sale price).

It is to be noted that Elbe did not retain any reversionary interest in the property; that it was not a sublessor but was an assignor and lost its depletable status.

Consequently, the language used by this Court in *Palmer v. Bender, supra*, that it did not make any difference whether the document constituted an assignment or a sublease was in effect limited by the *Elbe* case. The controlling fact question in the two cases was whether the transferor retained a reversionary interest in the lease.

The next depletion case of interest was *Helvering v. Bankline Oil Company*, 303 U. S. 362. There a gas processor had built a plant on oil property to treat gas obtained on a royalty basis from oil wells. The Court held that the taxpayer had acquired no right to produce gas and hence had no depletable interest though it had a large investment in the plant which would decline in value as the gas was produced.

In *Helvering v. O'Donnell*, 303 U. S. 370, a stockholder of a transferor company exchanged his stock for a share of the net profits to be derived from the properties in the hands of the transferee, but the Court held that the owner of the net profits right did not have a depletable interest as he could not enter, drill or produce and was a stranger to the property, despite the fact that he had an investment in its stock and was dependent on production of net income for the return of his investment.

In *Anderson v. Helvering*, 310 U. S. 404, the Oklahoma Company transferred leases to Anderson and was to receive a portion of the proceeds from the sale of oil, or a

portion of the proceeds from the sale of the property. The Oklahoma Company was to get 6% interest on the deferred payment and was to have a lien on the property. This Court held that the Oklahoma Company had entirely disposed of its depletable interest and that its right to receive a portion of the proceeds was merely a personal covenant since the Oklahoma Company's rights might be satisfied by a sale of the fee title and the company's right to receive consideration was not entirely dependent on the production of oil from the property. The Oklahoma Company retained no reversionary interest in the property and hence gave up its entire depletable interest.

In *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599, a landowner granted a lease for cash, a royalty and 20% of net profits. It, of course, through the lease, controlled the production and retained reversionary rights in the oil and hence retained a depletable interest in all of its receipts.

In *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25, an assignor transferred a lease to Burton-Sutton Oil Company for 50% of the net profits. The assignor also retained reversionary rights in the lease (11 T. C. 1190, par. 1 of contract) and hence retained a depletable interest in his 50% of the net profits. In other words, there was a sublease and not a complete assignment. Burton-Sutton Oil Company only acquired a depletable interest in 50% of the lease and the sublessor retained a depletable interest in 50% of the lease.

The above described cases clearly mark the line of demarcation between those who have acquired and retained depletable interests and those who have never acquired such interests or, having had them, have entirely disposed of them. The right to depletion follows the right to

enter, drill and extract or some portion or reversionary interest therein.

The regulations in effect in all the years in the case at bar clearly reflect these Supreme Court decisions and recognize the principles enunciated by the Circuit Court of Appeals in the instant case. Commissioner's Regulation 111, Section 29.23(m)(1), reads in part as follows:

> "* * * the owner of an economic interest *in mineral deposits* * * * is allowed annual depletion deductions * * *. An economic interest is possessed in every case in which the owner has acquired, *by investment*, any interest *in mineral in place* * * * and secures, by any form of legal relationship, income derived from the severance and sale of the mineral * * *, to which he must look for a return of his capital. *But a person who has no capital investment in the mineral deposit* * * * does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. *Thus, an agreement between the owner of an economic interest and another entitling the latter* * * * *to share in the net income derived from the interest of such owner does not convey a depletable economic interest.*" (Emphasis supplied.)

Respondent had the sole right to enter, drill and extract oil from the tideland lease and did not convey any of such interest to the upland owners. The upland owners have agreed that they acquired no such interest and have agreed that their contracts with the respondent did not give to the respondent any greater interest in the tideland or the tideland oil reserve than it had obtained directly from the State.

The contract between respondent and the upland owners provides that should respondent fail to pay the upland owners their rent, they can not cancel respondent's right to use their uplands but merely have a chose in action against the respondent who might have to pay rent even though it operates the lease at an over-all loss. This establishes that upland owners right to receive rent was merely a personal covenant and not an interest in the lease or the mineral reserve.

The upland owners' property was not depleted by the respondent's operations but was, in fact, being depleted by vertical wells drilled by their own lessee, the Standard Oil Company. The uplands were a part of the mineral property of which the Standard Oil Company was lessee and were not a part of the mineral property operated by respondent.

The decision of the Circuit Court of Appeals in the instant case is clearly correct as shown by the Regulations and by the Supreme Court cases defining depletable interests.

II.

There Is No Conflict of Decision.

Petitioner asserts that the decision in the instant case is in direct conflict with that of the Court of Claims in *Huntington Beach Company v. United States*, decided July 21, 1955, in which a Petition for Writ of Certiorari has also been filed.

It is believed that there is no conflict between the two decisions as the facts presented in the Court of Claims case are not the same facts as are presented in the instant case.

he important and pertinent facts set out under "State-
t" in this brief were introduced in the instant case
ereas they were either not introduced or argued in the
urt of Claims case.

These additional facts presented in the case at bar,
not presented in the *Huntington Beach* case, show con-
sively that respondent did not rent nor deplete the min-
l resources of the uplands; that the uplands were al-
dy being depleted by the Standard Oil Company opera-
s and the upland owners were entitled to depletion de-
tions on the royalties receivable from Standard Oil
mpany.

t was obvious to the Circuit Court of Appeals in the
ant case that the uplands could not be parts of two
eral properties and since their mineral resources were
ng depleted by the Standard Oil Company operation,
which they were receiving depletion deductions, the
ands could not be a part of the respondent's mineral
perty and the upland owners could not receive a second
of depletion deductions.

t is not clearly brought out in the Court of Claims
lings of fact, or opinion, that Southwest did not deplete
upland oil reserves or that the upland oil reserves were
ng depleted by their own lessee, or that the uplands
e a part of a mineral property of which the Standard
Company was lessee.

These are important and pertinent matters which should
ct the opinion of any court or judge and since they
e present in one case and not in the other, the two
isions are not in conflict.

Since the facts involved in the Court of Claims case are
the same as those presented in the case at bar, the de-

cision has no weight, as authority, upon the issue involved in the case at bar. The two decisions are not in conflict, because they do not "concern the same matter." (S. Ct. Rule 19(1)(b).)

III.

The Court of Claims Decision Is in Conflict With the Supreme Court Cases and Regulations.

Assuming that the Court of Claims in the Huntington Beach Company case understood or ignored the additional facts presented in the instant case, then the Court of Claims decision is clearly in conflict with the Supreme Court decisions on depletion and with the Regulations.

The Court of Claims allowed depletion to one who did not rent out its mineral resources, did not have any investment or rights in the State's mineral resources and who agreed that they did not acquire any interest therein.

The upland owners had no affirmative right to go upon or drill into the State tideland lease and acquired no such interest from the State or from respondent. The upland owners did not even have a lien or a covenant running with the land or with the State tideland lease. All they had was a personal chose-in-action, a personal covenant to receive rent.

Under these circumstances, the Court of Claims rendered a decision in conflict with the Supreme Court cases and with the Regulations. The Regulations specifically provide that a person who has no capital investment in the mineral deposit does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production; that an agreement between an owner of an economic interest and another entitling the latter to

hare the net income derived from the interest of such wner does not convey a depletable economic interest.

The Court of Claims decision definitely conflicts with he decision of the Supreme Court in *Helvering v. O'Donell*, 303 U. S. 370. There a stockholder of corporate oil roperty acquired the right to share in the net profits from he property but was held to be a stranger (no right to nter, drill or extract) and to have no depletable economic nterest. Surely the stockholder in that case had a more irect investment that did the upland owners in the case at ar but still he was held to have no depletable interest.

The Court of Claims decision conflicts with the decision f the Supreme Court in *Anderson v. Helvering*, 310 U. . 404. There an assignor of a lease was held to have etained no depletable interest though he was entitled to share of the gross proceeds, or to a share of the sale rice of the property, because he retained no reversionary nterest in the lease and could be paid off in some manner ther than through production.

The decision of the Court of Claims conflicts with the upreme Court decision in *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372. There a lessee ho once had a depletable interest sold its lease for cash nd a part of the net profits but retained no reversionary nterest in the lease and this Court held that the retention f a net profits share was not a retention of a depletable nterest. There the agreement of the parties was that lbe had completely parted with its interest in the proprty and this agreement was held to be of great imortance. In the case at bar the parties have agreed that he upland owners have no interest in the lease, and that hey have added no interest in the lease to respondent hich it did not acquire directly from the State itself,

and further agreed that their right to receive rent was merely a chose-in-action and could not be a basis for cancelling the right-of-way, and that the rent received could be retained even though respondent operated the property at an over-all loss. In their contract, the parties called the payment "rent" and not "royalty." Terminology used by the parties indicates their intent.

In all these Supreme Court cases the taxpayers who were held to have no depletable interests had investments which they exchanged for shares of net profit or gross proceeds, but they did not retain or acquire any right to go upon the property, drill and extract oil, and retained no control or reversionary interest therein.

Thus, the Court of Claims decision squarely conflicts with several Supreme Court decisions and with the Regulations, which are still in effect, and a Writ of Certiorari in the *Huntington Beach Company* case should be granted and the decision summarily reversed.

Under the Court of Claims decision depletion deductions might be allowed to owners of net profit interests who obtained same in consideration of (1) waiving a zoning ordinance preventing drilling of oil wells in the area; (2) granting a right of way over adjoining land to allow oil lessee to reach his leasehold land; (3) allowing labor union members to work on the oil well, (4) or allowing truck drivers to bring equipment to the oil well. Depletion deductions should be limited to those who have some interest or share in the right to enter, drill and extract oil.

IV.

There Is No Important Question of Federal Law.

The Petition represents that unless certiorari is granted in the instant case, as well as in the Court of Claims case, both decisions will become final and both taxpayers will receive depletion deductions on the same income and that this can only be avoided by the grant of certiorari in both cases.

The decision in the instant case is squarely in accord with the Regulations and the Supreme Court decisions, whereas the decision in the Court of Claims case is contrary to such authorities.

The Petition asserts that the two decisions, in the instant case and in the Court of Claims case, reflect uncertainty among the courts concerning the proper application of this Court's decisions and should be cleared up by the grant of Writ of Certiorari in both cases.

This Court can clear up the uncertainty by denying certiorari in the instant case and by granting it and summarily reversing the decision in the Court of Claims case, without the necessity of granting certiorari in both cases and having a full hearing on the merits.

This Court has handed down decisions on depletion matters in a large number of cases and has clearly marked the boundaries of depletable interests. The Regulations which are still in effect reflect the Supreme Court decisions and constitute a clear guide to proper construction of the Revenue Act on depletion matters.

Since the Government presented different factual situations and confusing arguments to the two Courts, it cannot be said that the Courts are in conflict.

The rejection of certiorari in the instant case, and the grant of certiorari and the summary reversal of the Court of Claims decision will be adequate to point out the true nature of a depletable interest.

The issue presented in the case at bar is unique because of the State law governing the development of the tide-land oil resources, and the provisions of the particular contracts and is not at all likely to be found again in any other situation.

Conclusion.

For the foregoing reasons it is respectfully submitted that this Petition for Writ of Certiorari should be denied.

Dated: September 20, 1955.

Respectfully submitted,

MELVIN D. WILSON,

Counsel for Respondent.

APPENDIX A.

Section 6873 of the Public Resources Code, Deering's California Code of 1944, contains clause (b) which provided as follows:

> "(b) Pollution and contamination of the ocean and tidelands and all impairment of and interference which bathing, fishing or navigation in the water of the ocean or any bay or inlet thereof is prohibited, and no oil, tar, residuary product of oil or any refuse of any kind from any well or works shall be permitted to be deposited on or pass into the waters of the ocean or any bay or inlet thereof." (Added by Stats. 1941, Chap. 548, Sec. 1, p. 1903.)

In 1945 by Statutes of California, Regular Session, Chapter 1393, Section 6873 of the Public Resources Code of California, was amended in subparagraph (a), by the addition of the following to the first sentence, as set forth on page 18 of the Appendix of the Petition "* * *, or shall be drilled or slant drilled to and into the subsurface of tide or submerged land covered by the lease, from a drill site located upon any pier heretofore constructed for drilling purposes and available for such drilling upon any tide or submerged land described in any valid, existing lease heretofore issued pursuant to the provisions of Chapter 303, Statutes of 1921, as amended, if in the judgment of the Commission such drilling will be in the public interest."

Article IV, Section 31, of the California Constitution, reads in part as follows:

> "The Legislature * * *; nor shall it have power to make any gift or authorize the making of

individual, municipal or other corporation whatever; * * *"

The Statute of California, Extra Session, 1938, Chapter known as "The State Lands Act of 1935" provided in art as follows. Section 31:

"All oil, gas, oil fields, coal, phosphate, sodium, gold, silver, and all other mineral deposits in land belonging to the State, or which may become the property of the State, are hereby reserved to the State * * *. Such deposits are reserved from sale except upon a rental and royalty basis as herein provided."

Section 39 of the State Lands Act of 1938 provided as llows:

"The Commission, in the name of the State of California, may purchase or receive by donation or lease any right of way or easement in real property, or any real property in fee simple, necessary or proper for sites for drilling operations, storage of oil, dehydrating plants, absorption plants, or other operations necessary or proper under this Act."

Section 40 of the State Lands Act of 1938 provided follows:

"The Commission, if it deems such action for the best interests of the State, may condemn, acquire, and possess in the name of the State any right of way or easement, including surface rights, or any operation authorized or contemplated under the provisions of this Act which may be necessary for the development and production of oil and gas from State owned lands and for their removal, transportation, storage, and sale, and for such purposes is authorized

of California to institute condemnation proceedings pursuant to Section 14 of Article I of the Constitution and the Code of Civil Procedure relating to eminent domain. The acquisition of such interest is hereby declared a public use * * *"

Section 41 of the State Lands Act of 1938 reads as follows:

"Any interest in land, or land in fee simple, acquired by the Commission by purchase, donation, lease, condemnation, or otherwise, may be made available to any lessee of the State for the purposes contained in this Act, and upon such terms and conditions as may be determined by the Commission."

BRIEF FOR THE RE-SPOND-ENT

No.

286

IN THE

preme Court of the

October Term, 1

No. 280.

ISSIONER OF INTERNAL REVE

vs.

TWEST EXPLORATION COMPA

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for the Ninth Ci

BRIEF FOR THE RES

United States

1955."

ENUE,

Petitioner,

NY; a corporation,

Respondent.

l States Court of Appeals
Circuit.

SPONDENT.

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I.

ndent possesses the sole depletable interest. The up-
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IN THE

Supreme Court of the United States

October Term, 1955.

No. 280.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

SOUTHWEST EXPLORATION COMPANY, a corporation,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENT.

Question Presented.

Respondent was the lessee of a State of California tideland oil deposit but in order to develop the lease without despoiling the beaches, was required to slant-drill its wells from uplands belonging to others who had no interest in the State Lease or deposit. Respondent rented the upland drill sites for an amount equal to 24½% of its net income from the State Lease.

But the right of the upland owners to receive rental was merely a personal obligation. Respondent could forfeit or abandon the State Lease without the consent of the upland owners. Respondent did not extract oil from

the tidelands and the upland owners were already entitled to depletion deductions on income received from the production of oil and gas from their own land. The State could only lease its tidelands where necessary to prevent drainage from upland vertical wells.

Did this rental constitute a royalty paid for the use of mineral deposits; which royalty must be excluded from the respondent's gross income from the State Lease for the purpose of computing depletion, or was it merely an ordinary rental for the use of a facility, a non-mineral property?

The court below held that the rent respondent paid the upland owners was not a royalty paid for the use of mineral deposits, as the upland owners had no interest in the State Lease or property and had no right to produce therefrom and could not give any such right to respondent.

Statutes and Regulations Involved.

The applicable statutes and regulations involved are set forth in the Appendix of this brief, pages 1 to 9, inclusive.

Statement.

In addition to the facts stated in pages 3 to 9, inclusive, of the petitioner's brief, respondent deems this additional statement of facts to be material.

Prior to 1929 the State of California permitted State lessees and oil operators to develop tideland oil deposits from piers, islands and barges. [Rep. Tr. p. 30.]

This practice threatened to result in waste petroleum

beaches of Southern California, and in 1938 the California Legislature passed the State Land Act of 1938, under which the State Land Commission was appointed, with power to lease and develop the tidelands in such manner as to prevent oil operations from despoiling the beaches. (Calif. State Lands Act of 1938, (Extra Session) Chap. 5, Secs 86, 87, 89, Appendix pp. 4-5.)

It was physically possible for respondent to have developed its tideland lease from piers, filled lands and barges and without the use of the uplands. [Rep. Tr. p. 30.] It could in 1938 and subsequently have made a drilling island which would have constituted "filled lands," from which it could have drilled, under the 1938 State Lands Act. (*Monterey Oil Company v. City Court of City of Seal Beach*, 120 Cal. App. 2d 31.) The testimony showed that if the State law were changed, respondent could at any time physically develop its State Easement No. 392 from filled lands, barges or piers. [Rep. Tr. p. 34.] The California law was so changed in 1955: California Public Resources Code; Stats. of 1955, Sections 6873 and 6873.1, pages 7, 8 and 9 of Appendix.

Beginning in 1923, Standard Oil Company of California drilled vertical wells on the uplands involved in this proceeding, and has produced oil from said uplands ever since. The upland owners were entitled to depletion deductions on their income from said oil production. [Rep. Tr, pp. 29-30; Joint Exs. 6-F and 7-G.]

All the wells drilled by respondent had their tops on the uplands and their bottoms under the ocean more than 200 feet away from the high tide as required by the State Lease and the agreement with the upland owners.

ands. [Stipulation, pars. 4, 14, 18; R. pp. 8-9, 14-15; Stipulation, par. 8; R. pp. 8, 14; Rep. Tr. p. 28.]

The agreement for Easement No. 392 [Ex. 5-E, par. 2-N; R. p. 35] prohibits the lessee from assigning or subletting the lease in whole or in part, without the written consent of the State Lands Commission. Exhibit 9-I (the agreement by which the respondent agreed to pay, as rental, an amount equal to 24½% of its net profits to the upland owners) was not among the agreements sent to the State Lands Commission for written consent.

If respondent failed to pay the upland owners the rental due them under the agreement of September 27, 1938 [Ex. 9-I], their only recourse would be to sue respondent for damages as they could not rescind the rights-of-way which entitled the respondent to drill its wells from their uplands. [Ex. 9-I, par. 13; R. p. 70.] Furthermore, should respondent operate the State Lease at a final overall loss, the upland owners would be entitled to keep the rental payments they have received out of current apparent profits. [Ex. 9-I, par. 14; R. pp. 70-71.] The upland owners' rights to receive rent was a personal obligation only and might have been payable out of respondent's capital, and was not solely payable out of net profits from the oil operations.

Respondent also wishes to emphasize the provisions of the contract with the upland owners, set out in small print as a footnote on pages 7 and 8 of petitioner's brief, to the effect that the upland owners have no interest in the State Lease or mineral property. [Exs. 9-I, R. pp. 70-73.]

Clarification of Record.

The sole issue in this case is whether respondent or the upland owners (including Huntington Beach Company) are entitled to depletion deductions on the amount equal to 24½% of respondent's net income from the State Lease which is paid as rent to the upland owners.

As shown by paragraph 20 of the Stipulation of Facts [R. p. 15], respondent makes payments to certain persons other than the upland owners of portions of the oil and gas produced, or the gross or net income therefrom. Among these persons are the owners of the 10-5/8% joint venture interest or joint working interest referred to in the Stipulation of Facts, paragraph 14 [R. pp. 11-12] and in the Tax Court's Findings of Fact, [R. p. 85.] These persons are not parties to this proceeding and the payments to them are not involved herein. Consequently, their interest will not be affected by the determination of the issues before the Court. Respondent is solely responsible for the payment to the upland owners of the entire 24½% rental, and the owners of the 10-5/8% joint working interest do not contribute thereto.

Because of the absence of any issue as to the said 10-5/8% interest and in the interest of simplification, the parties and the lower courts have in a few instances in their briefs and opinions ignored the existence of such interests. The Tax Court's opinion adopted by the United States Court of Appeals for the Ninth Circuit in its decision in one instance speaks of respondent as being the "sole owner" of the 100% working interest.

In the interests of brevity, respondent itself may in this brief still refer to itself as the sole owner of the

ense prejudicing or failing to recognize the status of the 0-5/8% interest, and the respondent invites recognition in the Court's opinion of said interest as it affirmatively appears from the record before this Court.

It has been urged upon respondent by the owners of the 10-5/8% interest that such recognition is important in order to obviate any confusion which may exist in the Internal Revenue Service as to the effect of the decisions by the lower courts.

Summary of Argument.

I.

Respondent has the exclusive right to produce oil and gas from the State Lease and is entitled to include in its gross income, subject to depletion deductions, all of the income from the property except for the royalties paid to the State of California.

The amount of rent respondent paid to the upland owners for the use of a facility is a mere deduction from gross income and not an exclusion therefrom because it is not a royalty paid for the use of the upland owners' mineral property.

The contribution of the use of the uplands and the right to receive rental in an amount measured by net income from the State Lease, did not give the upland owners an interest in the State Lease or mineral resource, and did not give respondent the right to extract oil or gas from the uplands. The amount paid the upland owners was merely a rental paid for a facility useful in the operation of the State Lease.

The State Lands Act of 1938 permitted the Lands Commission to grant leases on State mineral resources

only where necessary to prevent drainage from upland wells. A State Lease on the tidelands, therefore, would be in derogation of the upland owners' right or opportunity to extract, through drainage, from the State mineral resources. The State law required that the State mineral resources be developed in such a manner as not to despoil the beaches. It was apparent that this might result in the upland owners receiving some rent for the use of their non-mineral property but, of course, the State did not intend to give the upland owners any of the State's property or to make them co-lessors with the State. The State Constitution prohibits any gifts of State property to anyone. (Art. IV, Sec. 31 of the California Constitution, p. 3 of Appendix.) A conclusion that the upland owners in the case at bar had an interest in the State tideland oil resource would be contrary to the will of the people of California as expressed in their Constitution and in the State Lands Act of 1938.

The use by respondent of the uplands for its drill sites was not physically necessary. Respondent could have developed the State Lease from piers, barges or filled lands.

The upland owners had no right to extract oil from the State mineral resource or to give others such a right. The parties have agreed that (a) respondent obtained its sole right of extraction from the State and that (b) the agreement between the respondent and the upland owners did not reduce or modify the rights respondent received from the State and that (c) the upland owners did not give to respondent any rights in the State Lease which respondent did not get directly from the State of California, and (d) that the upland owners had no interest in the State Lease or mineral deposit.

The upland owners could give respondent no affirmative rights to extract from the State leasehold and did not have complete power to prevent respondent from using their uplands. Had the upland owners been unreasonable in their demands, the State of California could have condemned their uplands or rights-of-way therein and paid them cash sums for such amounts, not in any way dependent upon production from the State Lease and their lack of a depletable interest in the State land would have been altogether clear.

The upland owners derive their income, not from a natural resource in which they have any interest, but from an artificial resource, a legislative fiat which existed for a relatively short period of time. (Under the 1955 Amendment to the California Code, respondent could develop the State's natural resources without the use of the uplands.)

Respondent does not extract oil or gas from beneath the uplands, but merely uses their surface and subsoil, a non-mineral property.

The rent which respondent pays to the upland owners is not entirely dependent on profits from production. It may come from respondent's capital if respondent operates at an overall loss. If respondent fails to pay the upland owners the rent due them, they cannot cancel the right-of-way but can merely sue respondent for breach of contract. Therefore, their right to receive rent was a mere personal covenant.

In *Helvering v. O'Donnell*, 303 U. S. 370 and *Helvering v. Elbe Oil Land Company*, 303 U. S. 372, this Court decided that the mere right to receive a portion of the net profits of an oil lease held by one disassociated from

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the right to produce oil or gas does not give a depletable interest. These cases have been incorporated into the Regulations 111, Section 29.23(m)-1. This Regulation has never been criticized by this Court although it has been in effect since 1939 and has been approved by Congress by its enactment of many amendments to the Revenue Code since 1939 without any amendment to the section on depletion.

The petitioner argues that the upland owners' contribution of their drilling sites was comparable to the contributions by the taxpayers in *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599 and *Burton Sutton Oil Company v. Commissioner*, 328 U. S. 25, and should similarly carry to the upland owners a depletable interest in the State Lease. But in those cited cases the taxpayers who were held to have depletable interests had contributed positive, affirmative rights to drill and had retained reversionary interests therein, whereas the upland owners did not give to respondent the right to extract from the State resources but only furnished a physical facility.

Furthermore, the upland owners are already entitled to depletion deductions on royalties they receive from their own oil and gas deposits, and to give them another depletion deduction while denying one to an active producer who takes all the risks and incurs all the expense would discourage search for oil and gas and would thwart the will of Congress in allowing depletion deductions as encouragement for exploration of natural resources.

II.

The mere right to receive an amount of money equal a portion of the net profits from an oil lease is not de- able.

This Court has expressly held to this effect in *Helver- v. O'Donnell*, 303 U. S. 370, and *Helvering v. Elbe Land Company*, 303 U. S. 372. The Commissioner adopted that principle in his Regulation (Reg. 111, 29.23(m)-1).

The petitioner recognizes the soundness of this posi- when he admits that a holding to the contrary would uire an extension of the principles announced in by *Petroleum Company v. Commissioner*, 326 U. S. , and *Burton-Sutton Oil Company v. Commissioner*, U. S. 25, and the overruling of the two cases cited he preceding paragraph.

he petitioner does not appear to realize that a decision as he requests would also amount to a retroactive ruling of his Regulation, such retroactive applica- to go back seventeen years. The petitioner requests extreme action, not on the ground that the two s or the Regulation are contrary to law, but because hinks they are outmoded or inexpedient. Other phases hat subject will be covered in Part III hereof.

he petitioner's prayers or contentions must either eate a change of mind since his Regulation was writ- or a misinterpretation of the decisions of this Court he question of depletion. A study of the petitioner's f will show that it is the latter point rather than the er which impels petitioner at this time.

etitioner's misinterpretation of the Supreme Court is due to the fact that he concerns himself almost

wholly with the general expressions in *Palmer v. Bender*, 287 U. S. 551; *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599 and *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25; instead of concerning himself with the facts and holdings of all the cases decided by this Court involving the question of depletion.

That such an erroneous use of decisions as precedents is dangerous was set forth by this Court long ago in *Cohens v. The State of Virginia*, 6 Wheat. 264, 399, wherein Chief Justice Marshall warned against following general expressions in cases where the facts or issues in subsequent cases are different.

Several general expressions used by this Court in depletion cases might lead to the belief that the right to a share of the net profits from an oil lease is alone depletable but the actual holding of the cases on the facts involved clearly and consistently show that a depletable interest depends on having a right to enter, drill and extract, or to have a tenancy in common therein, or a partnership interest therein, or at least a right of reversion therein, together with the right to receive a share of the oil or gross or net profits therefrom.

An examination of the following cases indicates that the taxpayers who were allowed depletion deductions had and retained such rights. (*Lynch v. Alworth-Stephens Company*, 267 U. S. 364; *Palmer v. Bender*, 287 U. S. 551; *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599 and *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25.)

On the other hand, in the following cases it was held that the taxpayers who claimed depletion deductions had never acquired the right to enter, drill and produce or, having acquired that right, had entirely disposed of it.

Helvering v. Bankline Oil Company, 303 U. S. 362; *Helvering v. O'Donnell*, 303 U. S. 370; *Helvering v. Elbe Oil Land Company*, 303 U. S. 372 and *Anderson v. Helvering*, 310 U. S. 404.)

Furthermore, Regulations 111, Section 29.23(m)-1, mirrors all of the above mentioned cases, both those affirmatively allowing depletion deductions and those denying depletion deductions and was written in 1939 just after this Court had decided three depletion cases in which the right to depletion had been carefully defined.

The petitioner's request that the right to depletion deductions be extended to include all who have a right to share in the net profits of an oil lease, as distinguished from the present rule which limits depletion deductions to those who have some interest in the right to produce, is based upon a misconception of the holdings of this Court on the depletion principle. The petitioner has become confused by following the general expressions of this Court rather than its holdings upon the facts of the decided cases.

It is suggested that the present rule is much easier to administer than the one prayed for by the petitioner. The present rule has been in effect at least since 1938 and a reaffirmation thereof would require no retroactive change of principles, no retroactive application of the Regulations and no upsetting of an important industry.

It is believed that if petitioner understood this Court's depletion theory and that the Regulation still mirrors it, he would prefer the present principle rather than some undefined and undeveloped departure therefrom.

This Court, in several of the depletion cases cited above, held that there must be a determination in each case as to whether the parties intended on the one hand to grant

with, or on the other hand to acquire, the entire interest in the right to enter, drill and produce a mineral property.

Respondent had no intention of selling an interest in the State Lease to the upland owners and the upland owners expressly agreed that they were not acquiring any interest in the State Lease and that they were not becoming partners with respondent; that they had no interest in the lease or in the right to operate, modify, or cancel it. They should not be permitted to make a contrary claim at this time.

III.

When the petitioner asks this Court to overrule its decisions in *Helvering v. O'Donnell*, 303 U. S. 370, and *Helvering v. Elbe Oil Land Company*, 303 U. S. 372, on the ground that they announce a rule which is outmoded, or inexpedient, he is also asking this Court to overrule his Regulations 111, Section 29.23(m)-1, adopted in 1939.

That Regulation was written shortly after this Court had announced its decisions in the above-entitled cases and the Regulation truly mirrors the principles announced in those cases.

This Court has, since the Regulations were promulgated in 1939, announced three depletion decisions in *Anderson v. Helvering*, 310 U. S. 404 (1940); *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599 (1946) and *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25 (1946). In none of those cases did this Court criticize or question this Regulation or any aspect thereof.

Congress has, since 1939, amended the Revenue Code nine times but has not changed in any manner the statutory provisions for depletion deductions for oil and gas properties.

By principles announced by this Court in *Helvering v. Wilshire Oil Company, Inc.*, 308 U. S. 90, 100 (1939), and *United States v. Dakota-Montana Oil Company*, 288 U. S. 459, 466 (1933), the executive interpretation found in the Regulation has become the legislative interpretation. Congress also considers the Regulation to be in accord with this Court's interpretation of the Statute. (*Van Vranken v. Helvering*, 115 Fed. 2d 709, 710 (C. A. 2, 1940), cert. den. 313 U. S. 585 (1941).)

The Regulation is, therefore, valid and consequently has the force and effect of law. (*Maryland Casualty Company v. United States*, 251 U. S. 342, 349; *Helvering v. Winmill*, 305 U. S. 79, 83.) The Regulation and hence the law clearly indicates that the upland owners have no depletable interest in respondent's State Lease.

This Court invalidates a Federal law only when it is unconstitutional and never because it may be outmoded or inexpedient.

The Commissioner cannot change the Regulation retroactively when, by repeated re-enactment of the Statute, Congress has given its sanction to the existing Regulation, as to do so would repeal a rule of law that existed during the period for which the tax was imposed. (*Helvering v. R. J. Reynolds Tobacco Company*, 306 U. S. 110, 116; *Rasquin v. Humphreys*, 308 U. S. 54, 56.) If this Court were to change the rule of law announced in the Regulation in this case, it would result in great inequality in the administration of the law, which is a result to be avoided. (*Brewster v. Gage*, 280 U. S. 327, 337.)

The taxable years before this Court are 1939 to 1945, inclusive, and even though the Commissioner has not

asks this Court to write a new Regulation to take effect with retroactive effect for sixteen years.

Since the Regulation is valid and has the force and effect of law, a revision of it retroactively might be an encroachment upon the Legislative or upon the Executive branches of the Government. It is certain that this Court would hesitate to invade the provinces of these Departments of the Government.

It is believed that this Court would not hold a Treasury Regulation interpreting a Statute invalid unless it was clearly so, particularly when the Regulation accomplishes a result essentially fair to taxpayers and to the Government. (*Ramsey v. Commissioner*, 66 Fed. 2d 316, 318 (C. A. 10), cert. den. 290 U. S. 673.)

The Regulation in this case cannot be clearly shown to be invalid. Its fairness is attested to by the fact that it clearly follows the decisions of this Court and has legislative approval. The petitioner concedes that the revenue will not be affected regardless of which taxpayer is granted the depletion deduction.

It is the petitioner's prerogative to ask Congress to change the law or to change the Regulation prospectively. If he promulgates a new regulation it will be tested for validity, but the petitioner should not ask this Court to write a regulation for him to be retroactive for sixteen years, especially where the regulation involved clearly mirrors the decisions of this Court and has been approved by Congress and is consistent with the object of the statute to allow owners of the right to enter, drill and extract a

ARGUMENT.

I.

Respondent Possesses the Sole Depletable Interest. The Upland Owners Were Strangers to the Lease and Had a Mere Economic Advantage Which Under the Law Is Not an Economic Interest and Is Not Depletable.

Respondent will, to a certain point at least, follow the order of the petitioner's brief.

A. Introduction.

Respondent points out that under the agreement between respondent and the upland owners, respondent paid to them for the use of their land *"as rental an amount equal to 24½%* of the net profits from the property," rather than *24½% of the net profits from the property.* [R. p. 68.] (Emphasis supplied.)

It is believed that this distinction has a bearing on the intention of the parties, as will be set forth more fully hereinafter. Note that the parties did not designate the payment as "royalties," or even assign a share of net profits, but merely agreed to pay an amount of money measured by net profits, *as rental.*

B. General Principles Relating to the Deduction for Depletion.

Respondent has a different concept of this Court's decisions in theory, from that set out in petitioner's brief on pages 18 through 20. Respondent's views will be set out in Part II of this brief in response to Part II of the petitioner's brief.

C. The Upland Owners Rented to Respondent a Facility Only, Not Mineral Property.

The upland owners did not have any right to enter the State leasehold and produce oil or gas and did not contribute that right or any portion thereof to the respondent and hence the upland owners did not have or retain any depletable interest in the tideland lease.

Respondent merely paid rent to the upland owners for the use of their non-mineral property, a facility which was useful in the operation of respondent's State Lease. It did not rent from the upland owners a mineral property and hence did not pay them royalties which must be excluded from respondent's gross income for the purpose of computing depletion deductions.

The petitioner's brief does not refer to the testimony in this case that it would have been physically possible for respondent to have developed its tideland lease from piers, filled lands or barges and without the use of the uplands. [Rep. Tr. p. 30.] Furthermore, it could have made a drilling island which would have constituted "filled lands," (*Monterey Oil Company v. City Court of City of Seal Beach*, 120 Cal. App. 2d 31) from which it could have drilled under the 1938 State Lands Act.

Neither does the petitioner refer to the evidence introduced in this trial that all the respondent's wells were required to have their bottoms under the ocean more than 200 feet away from the high tide. [Stip. par. 8, 18; R. pp. 8, 15-16; Rep. Tr. pp. 8-9, 14-15] or that respondent has not taken any oil from beneath the uplands. [Stip., par. 8; R. pp. 8, 14; Rep. Tr. p. 28.]

Furthermore, on page 24 of his brief, the petitioner, in stating that the respondent was to pay a stipulated per-

ntage of its net profits to the upland owners in con-
leration of the rights granted by them to the respondent,
ils to mention some significant facts concerning that ar-
ngement. The contract stated that respondent was to
y "as rental an amount equal to 24½% of its net
ofits." [R. p. 9, Exs. 9-I, R. pp. 59-74.] Should the
spondent operate the State Lease at a final overall loss,
e upland owners were entitled to keep the rental pay-
ents they had received out of the current apparent
ofits. [Exs. 9-I, par. 14; R. pp. 70-71.] If respon-
nt failed to pay the upland owners the rental due them
der the agreement of September 27, 1938 [Exs. 9-I],
eir only recourse was to sue respondent for damages
d they could not rescind the rights-of-way which en-
led the respond to drill its wells from their uplands.
Exs. 9-I, par. 13, R. p. 70.] Hence, the upland owners'
ghts to receive rent was a personal obligation only and
ght have been payable out of respondent's capital and
as not solely payable out of net profits from the oil
erations.

2. Petitioner argues on page 24 of his brief that there
uld have been no production except with the consent of
e upland owners.

The petitioner overlooks the fact that, under the law
California, the State had statutory power to condemn
e uplands or the necessary rights-of-way, pay the up-
nd owners a cash sum and make those rights available
the respondent. (California State Lands Act, Sec. 40,
4 of Appendix.) In such an event, the upland owners
ould have had a cash sum not in any way dependent
on the production or net profits from the State Lease.
he money so received would have been either sale pro-

he use of their mineral property.

n page 25 of his brief the petitioner argues that the
ad owners made a capital investment by allowing the
of their land and that this will shrink in value as
oil is produced from the State Lease.

capital investment in oil in place is the right to enter,
and produce the oil. The upland owners never gave
a right to respondent. The upland owners had no
right and if the only right which respondent received
the right to go upon the uplands and drill, the respon-
could not have produced from the State Lease. The
t to go upon the State Lease and drill and produce
received from the State of California alone. Respon-
was the only one who had that right and the only
therefore, who had an investment in the oil in place.
upland owners agreed to these propositions when they
e making their arrangements with respondent. [Exs.
par. 13; R. p. 70.]

is true that the expectancy of the upland owners to
ive rent will decrease as the oil is extracted from the
and lease, but that was true in *Helvering v. O'Don-*
303 U. S. 370; *Helvering v. Elbe Oil Land Com-*
, 303 U. S. 372; *Helvering v. Bankline Oil Company*,
U. S. 362; and *Anderson v. Helvering*, 310 U. S.
Nevertheless, in those cases their similar rights
e held not to be investments in the oil in place, and
depletable interests.

etitioner in his brief, and the Court of Claims in *Hunt-*
on Beach Company v. United States, 132 Fed. Supp.
have given great importance to the use of the up-

nds in securing the State Lease and operating under it, nd to the fact that the California law required such use.

The attention of the Court is called to the fact that nder Section 86, California State Lands Act of 1938 Extra Session) c. 5 (App. p. 4), the Lands Commis-on was authorized to lease state tidelands only where was necessary to prevent drainage from upland wells. espondent was required to drill eleven wells offsetting even upland wells before it could drill other portions of s leased area. [R. pp. 44-45.]

It will be seen, therefore, that the State Lease was iven respondent as a step in derogation of the rights or pportunities of the owners of the uplands to participate n the State's oil resources.

A decision by this Court that the upland owners have n economic interest in the State's oil in place would nwart the effort of the people of California to protect neir natural resources from encroachment by upland wners.

Any suggestion that the State law made the upland wners a co-lessor with the State is erroneous, as it would mply a gift from the State to the upland owners, contrary o the provisions of Article IV, Section 31 of the Cali-ornia Constitution which prohibits gifts of State prop-rty. (App. p. 3.)

3. The petitioner argues, starting on page 25 of is brief, that the principles applied by this Court compel he conclusion that the upland owners had a depletable nterest even though they did not have the right to drill or and produce oil from the deposits under the State and.

o exploit the underlying minerals.

will be shown in Part II of this brief, Palmer d more than the right to receive royalties. He d the right to have the lease with its drilling rights ed to him in the event the assignee defaulted in his ions or wished to give up the lease. This Court that this placed Palmer in a position identical with a lessor who grants drilling rights with a right rsion.

page 27 of his brief, petitioner cites *Thomas v.* s, 301 U. S. 655, as being an instance where the r of exploitation rights was considered immaterial existence of a depletable interest, as there an assign- the lease still retained a depletable interest. The in that case was that when the lessee assigned the reserved from the assignment the right to take, or ive the benefits from, a portion of the oil. This he lessee-assignor a tenant in common with the e as to the right of production, and if the assignee iled to properly operate the property, the assignor have done so. Compare *Dabney-Johnson Oil Cor- n v. Walden*, 4 Cal. 2d 637, which held that the of a royalty received from a lessor becomes a ten- common of the right to drill in case of reversion of

in the case at bar the upland owners never had, ver will have, the right to drill and produce from

Burton-Sutton Oil Company v. Commissioner, 328

s. 25, reflects an instance where the transfer of ex-
ation rights in the oil deposits was considered im-
erial to the existence of a depletable interest, as the
e there had assigned the lease but still was entitled to
etion.

the *Burton-Sutton* case, *supra*, the lessee-assignor
ned more than the right to half of the net profits. He
ned the right to have the lease reassigned to him in
event the assignee wished to cease operations. See
ton-Sutton Oil Company v. Commissioner, 3 Tax
rt, page 1190, paragraph 1 of the agreement. Also,
lessee-assignor required the assignee to drill promptly
to sell the production to lessee if it desired. The
e-assignor and the assignee in that case became min-
partners and either could have operated the property
the other partner failed to do so. (*Skillman v. Lack-*
, 23 Cal. 198.) Several oil producing states have
ites on mining partnerships to the same effect. (Sum-
s Oil and Gas, Vol. 4, Note 3, pp. 142-144.)

his Court, itself, in the *Burton-Sutton* case, *supra*,
e 35, epitomized the depletion allowance to the assign-
in that case, as well as in *Kirby Petroleum Company*
ommissioner, 326 U. S. 599, as follows:

"Through retention of certain rights to payments
from oil or its proceeds in himself, each of these
assignors of *partial exploitation rights in oil land* has
maintained a capital investment or economic interest
in the oil or its proceeds." (Emphasis supplied.)

onsistently therewith in *Palmer v. Bender*, 287 U. S.
; *Thomas v. Perkins*, 301 U. S. 655 and *Burton-*

tion, supra, the taxpayers who were held to have de-
tâble interests retained control over production by hav-
g reversionary interests in the lease or the drilling
ghts, which is distinguishable from the uplanders' situa-
n in the case at bar. They never had, nor will they
er have, any drilling rights.

On page 28 of his brief, the petitioner compared the
ghts which the upland owners contributed in this case
the rights which the taxpayers contributed in the
lmer v. Bender, supra; Thomas v. Perkins, supra and
rton-Sutton, supra cases but overlooked the fact that
those cited cases the rights contributed were affirma-
e, positive rights to enter, drill and extract, whereas
the case of the upland owners they merely permitted
spondent to use a facility, but did not, and could not,
ve respondent the right to enter, drill and extract from
e leasehold property.

Petitioner, on pages 29 and 30 of his brief, quotes with
proval the example given by the Court of Claims in
untington Beach Company v. United States, 132 Fed.
pp. 718, of a hypothetical case where it was stated the
nter of the surface of the land would have a depletable
atus if it received a share of net profits for allowing
e oil lessee to use the surface for drilling operations.

It will be noted that neither the Court of Claims nor
e petitioner cite any authorities to support the suggestion
at the surface owner would have a depletable interest.
he effect of the absence of a decision along this line is
ted in 21 Corpus Juris Secundum 292, as follows:

> "The absence of reported judgments and decisions sustaining an alleged liability or a particular procedure, raises a strong presumption, or is persuasive

that no such liability or procedure is recognized." (*Western Union Tel. Co. v. Schriver*, 141 Fed. 538 (C. A. 8).)

Furthermore, it is well established that rents and royalties under an oil lease are not incident to the ownership of the surface, but of the reversionary estate in the minerals. (*Gillespie v. Blanton*, 214 Ky. 49, p. 52; 282 Southwestern 1061; *Way v. Venus*, Texas Civil Appeal. (8th Dist.), 35 Southwestern 2d 467; Summers Oil and Gas, Vol. 1, p. 487.)

The Board of Tax Appeals in *Brea Canyon Oil Company v. Commissioner*, 29 B. T. A. 1134 (1934), aff. 77 Fed. 2d 67 (C. A. 9, 1935) cert. den. 296 U. S. 604 (1935), in determining the gross income from the property by a producer of wet gas who had a plant on the property in which gasoline was extracted from the wet gas, on page 1140, said:

> "No part of that plant is property from which a natural resource is recovered."

Similarly, it is error to think that the upland surface produced some of the gross income from the State's mineral property, or forms the basis from which a depletion deduction would arise.

The surface of the uplands are part of the property of which the Standard Oil Company is lessee and the upland owners are receiving royalties from the Standard Oil Company lease and depletion deductions thereon. It would be indeed strange if the owners of the uplands were allowed two depletion deductions—one for the rental of their own mineral properties and another deduction for the rental of the surface and subsoil of their land, when

used by the operator of another mineral property. The Statute would hardly be construed as giving the owner of one property (uplands) two depletion deductions, while denying a full depletion deduction to an operator of another mineral property though he uses the surface of the uplands as a facility in his mining operations.

Petitioner, on page 31 of his brief, footnote 6, refers to the matter of compensatory or substitute royalty where an operator has leases on properties A and B and drills wells on property A which require offset wells to be drilled under his B lease. To avoid drilling offset wells, the lessee agrees to pay B a substitute royalty measured by the production from A's wells. It is suggested by petitioner that the owner of the B property is entitled to depletion deductions on the substituted royalty.

The Tax Court, in *P. T. Lake, Incorporated*, 24 Tax Court, No. 114, has been faced with a somewhat similar problem. Operators A and B had certain allowables for the production of oil under the law of Texas. A acquired an allowable certificate from B and produced more oil from A's lease than he otherwise could, and paid B so much per barrel of the additional amount allowed, whether produced or not. The Tax Court ruled that the payor and not the payee was entitled to the depletion deduction.

Other analogous situations suggest themselves. If the Court should allow the upland owners depletion deductions in the case at bar, how far would it extend the principle?

In the following examples, it will be assumed that the agreements included paragraphs similar to paragraphs 13, 14, 19 and 23 of Exhibit 9-I, page 70, 71, 72 and 73 of the Record.

Suppose oil lessee A obtained an oil lease from B whose operty is entirely surrounded by the property of C. will not give A a right-of-way to get onto B's property. less A agrees to pay C a rent equal to a share of the t profits from the lease. Would C have a depletable terest in the mineral content under B's land?

If so, suppose the labor union which furnished the ew for A's operations would not allow its members to ork on A's lease unless the union or the members re- ived, in addition to their wages, a sum equal to a share net profits from the lease. Certainly the workers are sential to the operations of the lease. Would they have depletable interest?

Suppose further, that B's property in the example given ove which was leased to oil operator A, is in an area hich is zoned against the drilling of oil wells. All the rrounding property owners, however, will waive the ning restrictions provided that A gives each of them sum equal to a share of the net profits from the lease. ould they have depletable interests?

Suppose further, that a lending institution is asked to an A, the lessee, $1,000,000.00 for drilling and other erating expenses but it will not do so unless A agrees give the company a sum equal to a share of net profits addition to interest on the loan. A cannot otherwise t the money. Would the lending institution be entitled depletion deductions?

These analogous situations are but samples of those hich could actually arise and pose the question as to w far the principle would go if this Court should ever le that a stranger, a person disassociated from the lease, ough he may have contributed an essential facility, is

entitled to depletion deductions merely because he has the right to receive some of the net income from the property. As is more fully brought out in Part II of this brief, it is believed that the better rule, and the one that has been adopted by this Court so far, is to limit the depletion deductions to those who have some share in the right to enter, drill and produce and who have retained some interest therein, often by right of reversion in such drilling rights (and have as well some share of the oil, or proceeds, or income therefrom).

4. On page 32 of his brief, the petitioner argues that the lack of a monetary investment in the oil in place is not fatal to a claim that the upland owners had a depletable interest, but this Court has held, as will be more fully shown in Part II of this brief, that regardless of the actual cost, to have a depletable interest the taxpayer must have a share in the rights to enter, drill and produce and, of course, the upland owners in this case had no such right and hence had no investment in the oil deposits.

This Court, in *Helvering v. Bankline Oil Company*, 303 U. S. 362, held that a monetary investment in a casing-head gas plant, a facility related to production of gas, was not an investment in the gas in place, as the plant operator did not produce gas and could not compel production.

On page 33 of his brief, the petitioner says that during the past 17 years the State of California has not enacted any changes which would permit the taxpayer to replace the present wells by new vertical wells. The petitioner points out the 1945 change but apparently has not noticed the 1955 amendments which permit islands to be made by "filling" and drilling to take place therefrom as well as from piers, floating platforms, or fixed structures, in, on

or over the tideland and whether or not contiguous to the littoral lands. (California Public Resources Code, Secs. 6873 and 6873.1.) (App., pp. 7-9.) While the Legislature in 1955 authorized islands to be made and used, case law permitted it even under the 1938 Act. (*Monterey Oil Company v. City Court of City of Seal Beach*, 120 Cal. App. 2d 31.)

At the present time, therefore, an operator could obtain a lease from the State of California and drill vertical wells from a "filled" island, a pier, or a floating or fixed platform.

The opportunity for the upland owners to rent their surface and soil for large annual payments, was a temporary and fortuitous circumstance. The money they receive therefor is a "windfall."

5. The petitioner argues on pages 34 and 35 of his brief that the upland owners contributed property which was essential to the production of oil and received an interest in production.

Again it is pointed out that while the upland owners furnished a facility, they did not give to the respondent any right to drill. The upland owners had no such right themselves nor could they give any to the respondent. Thus, the facts in this case are not distinguishable from those in *Helvering v. O'Donnell*, 303 U. S. 370, where the taxpayer also furnished no affirmative right to drill.

On page 35 of his brief, petitioner refers to *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599, and *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25, and indicates that the facts there are like the facts in the case at bar. But in those two cases the taxpayers who received depletion deductions gave rights to

drill and retained a reversionary interest in such rights in the event the lessee or assignee did not properly perform. Such was not the case with respect to the upland owners. They gave no rights to drill and will not, under any circumstances, receive the State Lease or any reversionary interest therein.

At the top of page 36 petitioner alleges that the upland owners' rights are not disassociated from an economic interest. This, of course, involves the definition of the word "disassociated" and will be more fully covered in Part II of this brief.

On pages 36 and 37 of his brief, the petitioner claims that the *Helvering v. Elbe Oil Land Company,* 303 U. S. 372, decision is not in point because the taxpayer there was not yet receiving any share of net profits. But this Court, in reaching its decision that the taxpayer had sold his lease despite the fact that he retained a share of net profits, carefully and fully considered the effect of the retention of the net profits interest and did not, in any sense, divide the case or the result between the period before net profits were being received and the period after net profits would be received. The Court considered the entire contract and the entire situation and held that the ownership of net profits was not enough to give depletable rights. In *Helvering v. Elbe Oil Land Company, supra,* the taxpayer parted entirely with his right to produce and had no reversionary interest therein after the $2,000,000.00 had been paid and after the net profits portion of the contract was in operation.

The petitioner, in Part I of his brief, says that if the ownership of a right to share in net profits, itself, is not sufficient to give the upland owners depletable status,

then the use, by respondent, of the surface and soil of their land (not their mineral resource) gives the upland owners a depletable interest in respondent's oil lease and deposit.

But the upland owners are already receiving depletion deductions from their land and nothing in the Statute or the decisions of this Court justifies granting to them another depletion deduction based upon, or dependent upon, the use of the same land.

II.

The Mere Right to Receive a Sum Equal to a Portion of the Net Profits From an Oil Lease Is Not Depletable.

In this portion of his brief, the petitioner, in asking this Court to extend the holdings in *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599, and *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25, and to overrule its decisions in *Helvering v. O'Donnell*, 303 U. S. 370 and *Helvering v. Elbe Oil Land Company*, 303 U. S. 372, shows confusion as to the true holdings of this Court's decisions in depletion cases.

This confusion is nowhere more apparent that in the fact that the Commissioner is, in effect, asking this Court to overrule Regulation 111, Section 29.23(m)(1) which is based on *Helvering v. O'Donnell, supra; Helvering v. Bankline Oil Company*, 303 U. S. 362; and *Helvering v. Elbe Oil Land Company, supra*, and which Regulation the Commissioner nowhere suggests is illegal. He only suggests that it is out of date and less expedient than a new policy which he, himself, has not yet in his Regulations adopted.

Regulations 111, Section 29.23(m)-(1), adopted in 1939 shortly after this Court rendered its decisions in *Helvering v. O'Donnell, supra; Helvering v. Elbe Oil Land Company, supra;* and *Helvering v. Bankline Oil Company, supra*, reads in part as follows:

> "* * * the owner of an economic interest *in mineral deposits* * * * is allowed annual depletion deductions * * *. An economic interest is possessed in every case in which the owner has acquired, *by investment*, any interest *in mineral in place* * * * and secures, by any form of legal relationship, income derived from the severance and sale of the mineral * * *, to which he must look for a return of his capital. *But a person who has no capital investment in the mineral deposit* * * * does not possess an economic interest merely because, through a contractual relation to the owner, *he possesses a mere economic advantage derived from production.* Thus, an agreement between the owner of an economic interest and another entitling the latter * * * *to share in the net income derived from the interest of such owner does not convey a depletable economic interest.*" (Emphasis supplied.)

If this Court renders the kind of decision the petitioner requests, it will amount to a holding that portions of that Regulation are invalid. Other aspects of that question will be discussed in Point III of this brief.

Petitioner recognizes that his theory of depletion conflicts with *Helvering v. O'Donnell, supra*, and *Helvering v. Elbe Oil Land Company, supra*, and cites articles by other commentators who are likewise confused as to the meaning of the decisions of this Court on depletion.

The theory of depletion as laid down by the
f this Court is clear if the *holdings* of the Court, on the
asis of the *facts* in the cases before it, are kept in mind
stead of relying on some of the general statements in
ese cases as the petitioner has done in his brief.

That lawyers, government counsel, even courts, some-
mes forget the important principle that the authority
f a former decision as a precedent is limited to the points
ctually decided on the facts before the Court, is well il-
strated by this Court's decision in *Commissioner v. Cul-
ertson*, 337 U. S. 733, wherein this Court found it
ecessary to restate the principles applicable to the use of
recedents in family partnership cases. That lesson was
nsufficient, however, and Congress felt it necessary to
urther clarify the matter. See Section 340 of the Rev-
nue Act of 1951, Public Law 181.

As was said by Chief Justice Marshall in *Cohens v.
The State of Virginia*, 6 Wheat. 264, 399:

> "It is a maxim not to be disregarded that general expressions in every opinion are to be taken in connection with a case in which those expressions are used. If they go beyond the case, they may be respected, but ought not to control the judgment in a subsequent suit, when the very point is presented. The reason of this maxim is obvious. The question actually before the court is investigated with care and considered in its full effect; other principles which may serve to illustrate it are considered in their relation to the case decided but their possible bearing on all other cases is seldom completely investigated."

In line with this general statement is a well supported
concept that while the doctrine of *stare decisis* relates only

is coextensive only with the facts on which it is founded. (21 Corpus Juris Secundum, p. 380.)

With those principles in mind an examination of the facts involved and the holdings in the depletion cases decided by this Court will show a very consistent theory of depletion.

The theory of depletion established by this Court limits depletion deductions to those who receive income from a mineral property and (a) have a right to enter, drill and extract the natural resource or (b) to those having that right who appoint others to carry on that work but retain control over the work by becoming partners or tenants in common with the assignee, or by having a reversionary interest in that right to enter, drill and produce. On the other side of the line is the taxpayer who does not acquire the right to enter, drill or produce, or having had that right, entirely disposes of it, though he may retain the right to receive a share of net proceeds or net profits.

The first of the cases establishing the depletion theory is *Lynch v. Alworth-Stephens Company*, 267 U. S. 364 (1925). There a lessee of mining property was held entitled to depletion deductions even though he did not have title to the ore in place. This Court held that the right to enter, drill and produce on a royalty basis was a property right having value which would lessen as the ore was produced and hence such a lessee was entitled to depletion deductions.

The next case, and the one that is perhaps the basis for the confusion, is *Palmer v. Bender*, 287 U. S. 551 (1933). There a lessee had appointed others to carry on the drilling work and the question was whether the

essee had retained a depletable interest. The lessee received a cash bonus, a future payment out of one-half of the first oil produced and an excess royalty of one-eighth of the oil produced. Also, as the facts will show, he retained a right of reversion in the leases, or became a partner with one of the appointees. Hence the lessee was held to be entitled to depletion deductions on all of his receipts.

There, the lessee, Palmer, transferred a half interest in a 40-acre Taylor Lease to the Gilliland Oil Company to be operated *in partnership* between Palmer and the oil company. As partner, Palmer, of course, could step in and operate the lease if the oil company failed to do so.

Palmer also transferred other portions of the Taylor Lease to the Ohio Oil Company for a cash payment and more cash to come out of the first half of the oil produced plus a one-eighth royalty and something for casinghead gasoline. On the day the apparent assignment was made, the Ohio Oil Company gave Palmer a letter to the effect that if Ohio wished to forfeit the lease it would reassign it to Palmer if he so requested.

Palmer also transferred drilling rights on other land to the Gulf Refining Company which agreed to operate and pay all expenses, pay a one-eighth royalty to the landowner, and to pay Palmer 60% of the oil and a one twenty-fourth oil royalty. The District Court in *Palmer v. Bender*, 49 Fed. 2d 316, page 324, said this arrangement under the civil law of Louisiana amounted to a sublease and Palmer had a right of reversion in the lease, the right to annul the lease, etc.

Now upon this state of the facts, this Court held that Palmer had owned and had retained a depletable interest

in all of these three leases. The Government had claimed that the agreements constituted sales in each case and that the taxpayer did not retain any depletable interest.

This Court, in *Palmer v. Bender*, 287 U. S. 551, where the transactions did amount to subleases, either by agreement or under Louisiana law, held that the taxpayer had retained a depletable interest under each arrangement and had not entirely parted with his depletable interest. Then this Court used language to the effect that it did not make any difference whether the instruments constituted assignments or subleases. This was, of course, true in that case as, under Louisiana law and the letter agreement, an apparent assignment amounted to a sublease. For other cases in which assignments of leases were held not to be sales, see *Wilson v. Cornbrooks*, 104 N. J. L. 418, 140 A. 292, and *Marcelle Inc. v. Sol & S. Marcus Co.*, 274 Mass. 469, 175 N. E. 83.

The petitioner interprets that language as meaning that Palmer could have retained a depletable interest even though he had parted with all present and future rights to exploit the minerals in place. Pages 26 and 27 of petitioner's brief. That this Court intended no such meaning to its language is shown by the fact that it cited *Palmer v. Bender*, 287 U. S. 551, in *Helvering v. O'Donnell*, 303 U. S. 370, as authority for the ruling that one who had no right to enter, drill and produce lacked a depletable interest even though he was entitled to receive a share of the net profits from oil properties. Also, in *Helvering v. Elbe Oil Land Company*, 303 U. S. 372, this Court denied depletion deductions to one who entirely parted with all rights to exploit, even though he retained a share of net profits. In doing so, this Court discussed

Palmer v. Bender, supra, but did not criticize the general comments it had used in the *Palmer v. Bender, supra*, decision to the effect that it was immaterial whether the lessee had assigned or merely subleased his lease.

The next depletion case decided by this Court was *Helvering v. Bankline Oil Company*, 303 U. S. 362 (1938). The issue there was whether a casinghead gas operator was entitled to depletion deductions on the difference between the value of the casinghead gas taken from the oil wells over the amounts the operator paid therefor. In that case the taxpayer erected a plant in an oil field to extract casinghead gasoline and other products from the wet gas, paying the oil and gas producers a share of the gross proceeds therefor. The operator took gas from the mouth of the wells and made a profit thereon. This Court in holding that Bankline was not entitled to depletion deductions gave as its reason the fact that it was not a producer of gas, that it had no interest or investment in the gas in place, and could not compel production. *This Court conceded that the operator had an economic advantage which would decline in value as the gas in the field was produced but held that that was not enough.*

In the same year (1938), this Court decided *Helvering v. O'Donnell*, 303 U. S. 370. There the stockholder of the San Gabriel Company (which owned oil properties) sold his stock to the Midway Company for one-third of the net profits to be enjoyed by the Midway Company from the assets formerly belonging to the San Gabriel Company which the Midway Company purchased. The question was whether the owner of that net profits interest was entitled to take depletion deductions and this Court held that he was not. The reason was that he had

no capital investment in the oil in place and he acquired no such interest; all he had was a personal covenant of the Midway Company, and an economic advantage which was not sufficient to give him a depletable interest though the recovery of his investment in the stock was dependent on the production of net profits from the property.

Also, in 1938 this Court decided *Helvering v. Elbe Oil Land Company*, 303 U. S. 372. There the lessee had transferred oil leases and the question was whether it had retained a depletable interest. The taxpayer received $350,000.00 in cash, was to get $1,650,000.00 over the next four years (without regard to the amount of production but only in the event the assignee did not forfeit the contract) plus one-third of the net profits after the assignee had reimbursed itself for all expenditures in the acquisition and development of the leases. If the assignee paid the $2,000,000.00, thereafter Elbe had no right of reversion in the properties. This Court held that Elbe, the lessee, had entirely parted with its depletable interest, had made an absolute sale of the leases and did not retain any investment or interest therein. It held that the share of net profits to be received was a personal covenant from the sale of the property and did not constitute income from the operation or rental of the mineral properties. This Court, page 375, again cited *Palmer v. Bender*, *supra*, for its holding that Elbe did not retain a depletable interest in the properties.

It will be noted that the actual holding of the Court in *Helvering v. Elbe Oil Land Company*, *supra*, where the instrument did amount to an assignment, differed from the language in the *Palmer v. Bender* case, 287 U. S. 551, mentioned above. This Court in *Palmer v. Ben-*

der, supra, said it was immaterial whether the instrument amounted to an assignment or a sublease (which was true in that case because an apparent assignment did amount to a sublease under the agreement or under Louisiana law) but here where the instrument did amount to an assignment it was found to be material and that the assignor had entirely lost its depletable interest.

The dictinction between the *holding* of this Court in *Palmer v. Bender, supra*, and some of the *general discussion* in that decision is most important. Failure to recognize that distinction has confused the Government and many lawyers and some courts and has beclouded the theory of depletion as set out by this Court in its actual holdings.

The next decision of this Court which indirectly involved the issue of depletion was *Anderson v. Helvering*, 310 U. S. 404 (1940). The question there was whether the taxpayer who had acquired an oil lease for $50,000.00 cash and $110,000.00 to be paid from half of the proceeds from production, or from sale proceeds of the property, had to exclude from his gross income from the property, the amounts paid to the assignor. The contract provided that all right, title and interest in the lease was being transferred to the taxpayer who paid six percent interest on the unpaid balance and gave a lien on a half of the oil and on the fee title. This Court held that the amount which the taxpayer paid under that contract was not a royalty and need not be excluded from taxpayer's gross income subject to depletion. This Court, as its reason, stated that the taxpayer had bought the lease; that an intention so to do was shown by the lack of reservation of oil in place; that deferred payments drew interest; that

the seller received a lien on the production and the fee title and the contract could be satisfied by payments from proceeds of the sale of the lease and not merely from production. This Court held that the right of the assignor to the payments called for by the contract were mere personal covenants on the part of the taxpayer.

This case also constituted a modification of the general discussion in the *Palmer v. Bender*, 287 U. S. 551, case as, here again, it made a difference whether the lessee who had assigned his lease to the taxpayer had really sold it or had subleased it.

As indicated before, after this Court had decided those three cases in 1938, *Helvering v. Bankline Oil Company*, 303 U. S. 362; *Helvering v. O'Donnell*, 303 U. S. 370; and *Helvering v. Elbe Oil Land Company*, 303 U. S. 372, the Commissioner in 1939 wrote Regulation 111, Section 29.23(m)-1 in its present form. That Regulation correctly reflects the theory of depletion as set forth by the Supreme Court in the cases decided up to that time.

The next depletion case decided by this Court was *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599 (1946). The issue there was whether the lessor who had leased his land for cash, a royalty and 20% of net profits was entitled to depletion deductions on the net profits received. In that case the lease, of course, was for a limited period of time and could be forfeited before the end of the term if the lessee did not properly perform the covenants of the lease. In any event, at the end of the lease the drilling rights would revert to the lessor. This Court held that the lessor was entitled to depletion deductions on the net profits receipts. This Court, as its reason, stated that prior to the lease the taxpayer had the sole

right to drill and produce and merely rented out its mineral resources, and the receipts therefor were from rent and not from the sale of the property.

This Court, in *Kirby Petroleum Company v. Commissioner, supra*, commented on but did not, in any way, overrule the three 1938 depletion cases, *Helvering v. Bankline Oil Company*, 303 U. S. 362; *Helvering v. O'Donnell*, 303 U. S. 370; and *Helvering v. Elbe Oil Land Company*, 303 U. S. 372, or *Anderson v. Helvering*, 310 U. S. 404.

As to *Anderson v. Helvering*, 310 U. S. 404 (1940), this Court in *Kirby Petroleum Company v. Commissioner, supra*, distinguished the two cases by pointing out that in *Anderson v. Helvering, supra*, the net proceeds share retained by the assignor was not depletable because the assignor might be satisfied out of the proceeds of the sale of the fee title and hence was not entirely dependent on production and that this was a personal covenant only.

This Court, in *Kirby Petroleum Company v. Commissioner, supra*, distinguished *Helvering v. O'Donnell*, 303 U. S. 370, by pointing out that the later case involved a situation where the right to receive a share of net profits was not depletable because received by a stranger to the lease who had no right to drill or produce.

This Court in *Kirby Petroleum Company v. Commissioner, supra*, distinguished *Helvering v. Elbe Oil Land Company*, 303 U. S. 372, on the ground that in the latter case it held that the net profits share there was not depletable because the recipient retained no interest in the lease, having sold it and entirely parted with all rights to drill and produce.

Consequently, this Court in *Kirby Petroleum Company v. Commissioner, supra*, did not in any manner whatsoever criticize its earlier decisions in *Helvering v. O'Donnell, supra; Helvering v. Elbe Oil Land Company, supra;* or *Anderson v. Helvering, supra*, but clearly distinguished them.

The next and last depletion case is *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25 (1946). The question there was whether the assignee of a lease from the lessee was entitled to depletion deductions on the entire income from the lease. The facts were that the taxpayer-assignee had agreed to pay half of the net profits to the assignor and to reassign the lease to the assignor in case the assignee wished to cease operations. See paragraph 1 of the agreement set forth in *Burton-Sutton Oil Company v. Commissioner*, 3 Tax Court, page 1190. In that case it is doubly clear that Gulf, the assignor, did not intend to part with its entire interest because of the fact that, under the agreement, it required the assignee to drill promptly. This Court held that the assignee was entitled to depletion deductions on half only of the income from the leases. This Court said that the assignor had retained a depletable interest in half of the net income of the lease by virtue of its retention of half the net profits and retention of a portion of the exploitation rights. This is shown by the language of this Court at page 35, as follows:

> "* * * Through retention of certain rights to payments from oil or its proceeds in himself, each of these *assignors of partial exploitation rights* in oil lands has maintained a capital investment or economic interest in the oil or its proceeds." (Emphasis supplied.)

In *Burton-Sutton Oil Company v. Commissioner, supra,* this Court again noted its decisions in earlier depletion cases but instead of overruling them or criticizing them, distinguished them.

Instead of overruling *Helvering v. Elbe Oil Land Company,* 303 U. S. 372, this Court pointed to it as an example of a situation where a landowner or other owner of rights to drill could completely divest himself of any interest in his exploitation rights. If so, he receives sale proceeds and not rent from mineral properties. This Court, pages 35-36, said that in each case there must be a determination of whether the transferor has made an absolute sale or has retained a portion of the exploitation rights and some possibility of further profit. It is a question of intention and the intention must be drawn from express provisions of the contracts or from the other provisions therein. The Court pointed to *Anderson v. Helvering,* 310 U. S. 404, as an example of where the assignor could be satisfied by future sales of the property without extraction of the oil. The Court cited *Thomas v. Perkins,* 301 U. S. 655, as an example of where the lease could otherwise be assigned but there could be reserved from that assignment a portion of the oil. In such a case the assignor and assignee would become tenants in common of the right to drill and the assignor could drill if the lessee improperly failed to do so. See page 21 of this brief for a further discussion of this point.

Thus, it will be noted that in all the decisions of this Court in which the taxpayer acquired or retained a depletable interest, he also acquired and retained exploitation rights—the right to enter, drill and extract, or a partnership interest therein, or a tenancy in common

interest therein, or at least control over such rights through the power to annul the lease or reacquire the right to drill. (*Lynch v. Alworth-Stephens Company*, 267 U. S. 364; *Palmer v. Bender*, 287 U. S. 551; *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599; and the assignor in *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25.)

On the other hand, where the taxpayers were held to lack depletable interests, it was found that they did not acquire the right to enter, drill and produce; *Helvering v. Bankline Oil Company*, 303 U. S. 362; or, having had that right, they had entirely disposed of it. (*Helvering v. Elbe Oil Land Company*, 303 U. S. 372; and *Anderson v. Helvering*, 310 U. S. 404.)

With this Court's depletion theory thus marked, delineated and reconciled, it is apparent where the upland owners stand. They did not have and never will acquire the right to enter, drill and extract from the State tideland lease. Hence, under this Court's depletion theory, the upland owners did not acquire a depletable interest. They merely acquired an economic advantage, a personal covenant, and might receive their money out of respondent's capital.

It is, of course, agreed that in order to have depletion rights, one must have "an economic interest in the minerals in place." It is believed that the decisions of this Court have defined such interest as coincident with the right, present or contingent, to enter the lands and drill or extract minerals therefrom. But even if this Court does not entirely accept respondent's analysis of the decisions on this point, it is undisputed that there must be some form of ownership in the production of minerals from

the land. A mere agreement to receive net profits derived from such production is not *per se* sufficient (*Helvering v. O'Donnell*, 303 U. S. 370.) A person who has such an economic interest, such as an owner of the fee, or a lessee, may retain such an interest when he makes a lease, a sublease or a partial assignment, even though he agrees to receive his rental in the form of net profits from the oil operation (*Kirby Petroleum Company v. Commissioner*, 326 U. S. 599; and *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25). But here the upland owners were strangers to the lease. Through a contractual arrangement with the lessee, they obtained the right to receive as rental for their non-mineral property an amount equal to a percentage of the net profits from the production. This, under the authorities and the applicable Regulation, was a mere economic advantage and not a depletable economic interest.

That the upland owners did not receive, and that the parties did not intend that they should receive, an assignment of any part of lessee's interest, is clear.

Intention was considered material in *Helvering v. Elbe Oil Land Company*, 303 U. S. 372, and in *Anderson v. Helvering*, 310 U. S. 404. In *Burton-Sutton Oil Company v. Commissioner*, 328 U. S. 25, this Court said, page 35, that in each case there must be a determination of whether the transferor has made a sale or not and, of course, intention is always material in determining the nature of a transaction.

The question of intention in this case is definitely settled by the express contracts of the parties themselves. Exhibit 9-I, entered into between respondent and the upland

owners, in paragraph 19 [R. pp. 72-73] reads as follows:

> "This agreement shall not be construed to give second parties (upland owners) any right, title or interest in said State Lands or in or under said State easement, * * *"

Paragraph 13 of said agreement [R. p. 70] reads:

> "It is understood and agreed that nothing herein shall add to, modify, or limit the * * * rights given to Southwest under said State easement, * * *"

Paragraph 23 of said contract [R. p. 73] provides that the upland owners and respondent shall not become partners.

Furthermore, the easement with the State [Ex. 5-E, Sec. 2-N] provides that respondent shall not assign, transfer or sublet the State lease to any person without the prior consent in writing of the State Lands Commission. [R. p. 35.] Neither respondent nor the upland owners sent the contract known as Exhibit No. 9-I (agreement by which respondent agreed to pay, as rental, an amount equal to 24½% of its net profits to the upland owners) to the State Lands Commission for its written consent thereto as constituting an assignment of an interest in the State Lease.

It is difficult to conceive how the upland owners and respondent could have more clearly set forth their intention that the upland owners were to have no interest in the lease than they have done by the written agreements entered into between them at the initiation of this arrangement. The upland owners have no voice in the operation

of the lease, have no money invested in it, do not incur any expenses of operation, can not prevent its amendment or adoption or cancellation by the respondent and are not, under any circumstances, to receive any portion of the lease even should respondent decide to withdraw therefrom.

The upland owners were indeed fortunate to be able to rent their idle land and to receive a large annual income therefrom. They were already receiving depletion deductions from income received from the mineral resources under their land. They should be willing to pay income taxes on this rental for the use of the surface of their land without attempting to take from respondent its depletion deduction which was allowed by Congress to encourage the development and production of natural resources. No natural resource of the upland owners is being used up by respondent. They are getting their rental income from a temporary, artificial resource, a legislative fiat. The upland owners have agreed that they had no interest in the lease or deposits and should be estopped from taking an inconsistent position. It would be most inequitable and inimical to the interests of the country to give such passive suppliers of facilities a double depletion deduction while denying it to the operator who took all the risks and incurred all the expenditures.

The respondent cannot believe that this Court will countenance such a plea as that made by petitioner and the upland owners in the case at bar.

III.

The Petitioner Is Asking This Court to Exercise a Legislative or Executive Function When He Indirectly Asks This Court to Amend or Annul the Regulations, Not on the Ground That They Are Invalid, but That They Are Out of Date or Inexpedient.

It is worthy of notice that the Commissioner, in his brief, does not mention, except in the Appendix, his Regulations 111, Section 29.23(m)-1, promulgated in 1939.

This Regulation is set out on page 1 of the Appendix of this brief and is abstracted on page 31 hereof.

As heretofore stated, the Regulation in this form was adopted in 1939 after this Court had decided *Helvering v. Bankline Oil Company*, 303 U. S. 362; *Helvering v. O'Donnell*, 303 U. S. 370; and *Helvering v. Elbe Oil Land Company*, 303 U. S. 372. It will be noted that the negative parts of the Regulation truly mirror the holdings of this Court in those cases, while the affirmative portions of that Regulation mirror the holdings of this Court in *Lynch v. Alworth-Stephens Company*, 267 U. S. 364, and *Palmer v. Bender*, 287 U. S. 551.

In 1939 the Commissioner undoubtedly understood the three latest decisions of this Court and was ready to follow them and wrote a valid regulation strictly in accordance therewith.

Since that Regulation was promulgated in 1939 this Court has never criticized that Regulation nor held any portion of it to be invalid, or contrary to law, or in conflict with the decisions of this Court.

Furthermore, Congress in enacting the Revenue Act of 1940, Public Law No. 656, dated 6-25-40; the Revenue

Act of 1941, Public Law No. 250, enacted 9-20-41; the Revenue Act of 1942, Public Law No. 753, enacted 10-21-42; the Revenue Act of 1943, Public Law No. 235, enacted 3-25-44; the Revenue Act of 1945, Public Law No. 214, enacted 11-8-45; the Revenue Act of 1948, Public Law No. 471, enacted 4-2-48; the Revenue Act of 1950, Public Law No. 814, enacted 9-23-50; the Revenue Act of 1951, Public Law No. 183, dated 10-20-51; the Revenue Code of 1954, Public Law No. 591, dated August 16, 1954, has never, since the Regulations were promulgated in 1939, changed, in any manner, the statutory provisions for depletion deductions for oil and gas properties.

When Congress re-enacts a statute which has received executive interpretation it is considered to have given implied legislative recognition and approval to such executive interpretation, as Congress is presumed to have legislated with knowledge of an established usage of an executive department of the Government. In other words, the executive interpretation, in such a case, becomes the legislative interpretation. (*Helvering v. Wilshire Oil Company, Inc.*, 308 U. S. 90, 100 (1939); *United States v. Dakota-Montana Oil Company*, 288 U. S. 459, 466 (1933).)

Consequently, Congress considers that Regulation valid and in accordance with its intent and with this Court's interpretation of the Statute. (*Van Vranken v. Helvering*, 115 Fed. 2d 709, 710 (C. A. 2, 1940), cert. den. 313 U. S. 585 (1941).)

Since this Regulation clearly reflects the decisions of this Court handed down just prior to the promulgation of this Regulation and this Court has never criticized such

Regulation, it is obvious that the Regulation is considered by this Court to be valid.

Regulations have the force and effect of law insofar as not inconsistent with express statutory provisions. (*Maryland Casualty Company v. United States*, 251 U. S. 342, 349; *Helvering v. Winmill*, 305 U. S. 79, 83.)

The Commissioner does not even now suggest that the Regulation is invalid but merely that it is outmoded and not as expedient as some newly contemplated regulation which he has not even outlined. He concedes that his new concept of depletion is not clearly covered by any decision of this Court, and that it is clearly contrary to several decisions of this Court. If the Commissioner understood the Court's depletion theory, and that the Regulation still truly reflects it, he would likely not think the Regulation outmoded or needful of change.

The Commissioner asks this Court to, in effect, amend his Regulations with retroactive effect although he, himself, has not yet written the new retroactive Regulation nor even promulgated one to take effect only in the future.

This Court has held in *Helvering v. R. J. Reynolds Tobacco Company*, 306 U. S. 110, 116 (1939) that the power to issue regulations with retroactive effect in an instance where, by repeated reenactment of the Statute, Congress has given its sanction to the existing regulation, may not be exercised in such a manner as to repeal the rule of law that existed during the period for which the tax was imposed. To the same effect, see *Rasquin v. Humphreys*, 308 U. S. 54, 56.

It would be shocking if this Court were to set aside a regulation which undoubtedly is valid as shown by the implied approval of this Court and of Congress, merely be-

use it was outmoded or inexpedient and to make that nendment retroactive. This would result in great in- quality in the administration of the law and regulation, nd hence is to be avoided. (*Brewster v. Gage*, 280 U. S. 27, 337.)

The taxable years before this Court are 1939 to 1945, nclusive, and even though the Commissioner has not dopted a new regulation to take effect prospectively, he sks this Court to write a new regulation to take effect ith retroactive effect for sixteen years.

Since the Commissioner is not suggesting that his Reg- lations, adopted in 1939 and approved by implication y this Court and by Congress, are invalid, his request nat this Court change the Regulation can only be con- dered as a request for this Court to exercise a legislative r executive function.

While this Court has unlimited authority to construe ne constitutionality of statutes and to interpret statutes, o Court is given the authority by the Constitution to etermine what the law should be, or to make laws (*Fed- ral Radio Commission v. Nelson Bros. Bond & Mortgage ompany*, 289 U. S. 266, 275; 16 Corpus Juris Secun- um 427); or to determine what is for the common good r public welfare (*License Tax Cases*, 72 U. S. 497, 500, Wall. 462, 469); or to select the subjects of taxation *Mitten Bank Securities Corporation v. United States*, D. C. E. D. Pa. 24 Fed. Supp. 198, 199); or to prescribe lassifications (*Bells' Gap Railroad Company v. Pennsyl- ania*, 134 U. S. 232, 237); or exemptions under tax tatutes. (*Henneford v. Silas Mason Company* (Wash- ngton), 300 U. S. 577, 587 (1937).)

The principle is well established that where a law is within the power of the legislature and was properly enacted, the courts are bound thereby and must enforce such law as written. (*Mobile County v. Kimball*, 102 U. S. 691; *Crooks v. Harrelson* (C. A. 8), 35 Fed. 2d 416, aff. 282 U. S. 55, 60.) The Regulation in the case at bar constitutes such a law and definitely upholds and protects respondent. Also, it is established that a court cannot enforce or promulgate a rule in conflict with a valid enactment. (*Klein, Messner Company v. United States*, 13 Court of Customs Appeal 273.) It is held that these prohibited acts can not be done directly or by judicial construction (16 Corpus Juris Secundum, p. 453) unless, of course, the legislative enactment is clearly in excess of the legislative powers. It is said that an action of such character upon the part of the courts is discountenanced as an encroachment upon the legislative branch of the Government regardless of the desirability of such action (*Ayers v. Parker*, D. C. Md., 15 Fed. Supp. 447, 452), or because of changed conditions (*South Shore Utility Company v. Railroad Commission of Wisconsin*, 207 Wis. 95, 240 N. W. 784, 788), or because of the happening of events probably not foreseen by the Legislature (*Corn Exchange Savings Bank v. Smith*, 59 S. D. 182, 239 N. W. 186, 189), or because of considerations going to the motive, policy, wisdom or expediency of the Legislation. (16 Corpus Juris Secundum 471-478.)

In other words, generally courts will not inquire into the motive, policy, wisdom or expediency of legislation except as an aid to proper interpretation. These rules are applied to taxation (*La Belle Iron Works v. United States*, 256 U. S. 377; *United States v. Jacobs*, 306 U. S. 363, 372); to income taxes *Kingan & Company v. Smith*

(D. C. S. D. Ind.), 17 Fed. Supp. 217, 222); to deductions and allowances in tax statutes (*Phipps v. Commissioner* (C. A. 10), 91 Fed. 2d 627, 629, cert. den. 302 U. S. 742; *Twin Bell Oil Syndicate v. Helvering* (C. A. 9), 70 Fed. 2d 402, 410 (reversed on other grounds, 293 U. S. 312).)

Because of these principles it is certain that this Court, for fear of encroaching upon the legislative function, will hesitate to change the rule of law retroactively on the ground that though the law is not invalid, it is outmoded or inexpedient.

Furthermore, even at the request of an executive officer, this Court will, it is believed, hesitate to change this rule of law established by a valid regulation long in effect for fear of possible encroachment upon the Executive Department.

One of the functions of the Executive Department is to make rules and regulations and this function is not given to the courts. (*Perkins v. Lukens Steel Company*, 310 U. S. 113, 127, and 16 Corpus Juris Secundum, page 492. This applies to the regulations of the Treasury Department. (*City Bank Farmers Trust Company v. Hoey* (C. A. 2), 125 Fed. 2d 577, 579.) The principle is established that a Treasury Regulation interpreting a statute must be clearly shown to be invalid before a court is justified in holding an action under it illegal, particularly when the regulation accomplishes a result essentially fair to taxpayers and to the Government. (*Ramsey v. Commissioner*, 66 Fed. 2d 316, 318 (C. A. 10), cert. den. 290 U. S. 673.)

Respondent suggests that it cannot be clearly shown that this Regulation is invalid. Its fairness is attested to

by the fact that it clearly follows the decisions of this Court and has implied legislative approval. Petitioner concedes that the revenue will not be affected whichever way the decision in this case goes.

If the Commissioner wishes to change his Regulations for the future, let him do so, and his new Regulation will be tested for validity. But he should not ask this Court to write a regulation for him, to be retroactive even one year, let alone sixteen years, especially where the regulation involved clearly mirrors the decisions of this Court, has been impliedly approved by Congress many times, is entirely fair, and consistent with the theory of depletion established by this Court and comports with logic, good sense and the object of the statute to allow owners of the right to enter, drill and extract, to deduct from the income derived from that right their investment therein.

Conclusion.

The decision of the Court of Appeals should be affirmed.

Dated: December 23, 1955.

Respectfully,

MELVIN D. WILSON,

Counsel for Respondent.

APPENDIX.

Internal Revenue Code of 1939.

Sec. 23. Deductions From Gross Income. * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. (26 U. S. C. 1952 Edition, Section 23.)

Sec. 114. Basis for Depreciation and Depletion. * * *

(b)(3) Percentage depletion for oil and gas wells.—In the case of oil and gas wells the allowance for depletion under Section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph. * * * (26 U. S. C. 1952 Edition, Section 114.)

Treasury Regulation 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(m)-1. Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements.—Section 23(m) provides that there shall be allowed as a deduction in computing net income

in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * * * * * *

(b) A "mineral property" is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(c) The term "mineral deposit" refers to minerals in place. The cost of a mineral deposit is that proportion

of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

* * * * * * * * *

(i) "The property," as used in Section 114(b)(2), (3), and (4) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. * * *

Section 19.23(m)-1 of Treasury Regulations 103, promulgated under the Internal Revenue Code of 1939, applicable to the years 1939 through 1941, is substantially the same as Section 29.23(m)-1 of Treasury Regulations 111.

California Constitution:

Article IV, Section 31, reads in part as follows:

"The Legislature * * *; nor shall it have power to make any gift, or authorize the making of any gift; of any public money or thing of value to any individual, municipal or other corporation whatever; * * *".

Article XV, Section 3, reads as follows:

"All tidelands within two miles of any incorporated city or town in this State, and fronting on the waters of any harbor, estuary, bay, or inlet used for the purposes of navigation, shall be withheld from grant or sale to private persons, partnerships, or corporations."

Statutes of California, California State Lands Act of 1938 (Extra Session), c. 5:

Sec. 31. All oil, gas, oil shale, coal, phosphate, sodium, gold, silver, and all other mineral deposits in lands belonging to the State, or which may become the property of

the State, are hereby reserved to the State. * * * Such deposits are reserved from sale except upon a rental and royalty basis as herein provided. * * *

Sec. 40. The commission, if it deems such action for the best interests of the State, may condemn, acquire, and possess in the name of the State any right of way or easement, including surface rights for any operation authorized or contemplated under the provisions of this act, that may be necessary for the development and production of oil and gas from state-owned land and for their removal, transportation, storage, and sale, and for such purposes is authorized and empowered in the name of the people of the State of California, to institute condemnation proceedings pursuant to section 14 of Article I of the Constitution and the Code of Civil Procedure relating to eminent domain. The acquisition of such interests is hereby declared a public use. * * *

Sec. 41. Any interests in lands, or lands in fee simple, acquired by the commission by purchase, donation, lease, condemnation, or otherwise, may be made available to any lessee of the State for the purposes contained in this act and upon such terms and conditions as may be determined by the commission.

Sec. 86. Whenever it appears to the commission that oil or gas deposits are known or believed to be contained in any such lands and may be or are being drained by means of wells upon adjacent lands not owned by the State, the commission shall thereupon be authorized and empowered to lease any such lands, either as a tract or in parcels of such size and shape as the commission shall determine, for the production of oil and gas therefrom, in the manner provided in this article.

Sec. 87. The commission shall prepare a form of lease which shall contain, in addition to other provisions deemed desirable and necessary by the commission, appropriate provisions contained in this act and the following:

(a) Each well drilled pursuant to the terms of such lease shall be drilled only upon filled lands or shall be slant drilled from an upland or littoral drill site to and into the subsurface of the tide or submerged lands covered by the lease. The derricks, machinery, and any and all other surface structures, equipment, and appliances shall be located only upon filled lands or upon the littoral lands or uplands, and all surface operations shall be conducted therefrom.

(b) Pollution and contamination of the ocean and tidelands and all impairment of and interference with bathing, fishing or navigation in the waters of the ocean or any bay or inlet thereof is prohibited, and no oil, tar, residuary product of oil or any refuse of any kind from any well or works shall be permitted to be deposited on or pass into the waters of the ocean or any bay or inlet thereof.

Sec. 89. In any notice of intention to lease tide or submerged lands, the commission may include a requirement that each prospective bidder, as a condition precedent to the consideration of his bid and in addition to the other qualifications required by this act, shall present evidence satisfactory to the commission of his present ability to furnish all necessary sites and rights of way for all operations contemplated under the provisions of the proposed lease. In such event the commission shall reject the bids of all bidders who fail to qualify as provided by this section.

Statutes of California, Regular Session 1945, Chapter 1373, Section 1:

"Section 6873 of the Public Resources Code is amended to read:

Section 6873. The commission shall prepare a form of lease which shall contain, in addition to other provisions deemed desirable and necessary by the commission, appropriate provisions contained in this chapter and the following:

"(a) Each well drilled pursuant to the terms of such lease shall be drilled only upon filled lands or shall be slant drilled from an upland or littoral drill site to and into the subsurface of the tide or submerged lands covered by the lease, *or shall be drilled or slant drilled to and into the subsurface of tide or submerged lands covered by the lease, from a drill site located upon any pier heretofore constructed for drilling purposes and available for such drilling upon any tide or submerged lands described in any valid existing lease heretofore issued pursuant to the provisions of Chapter 303, Statutes of 1921, as amended, if in the judgment of the commission such drilling will be in the public interest.* The derricks, machinery, and any and all other surface structures, equipment, and appliances shall be located only upon filled lands or upon the littoral lands or uplands, or upon any pier heretofore constructed and available for such drilling upon any tide or submerged lands described in any valid existing least heretofore pursuant to the provisions of Chapter 303, Statutes of 1921, as amended, and all surface operations shall be conducted therefrom.

(b) Pollution and contamination of the ocean and tidelands and all impairment of and interference with bathing,

fishing or navigation in the waters of the ocean or any bay or inlet thereof is prohibited, and no oil, tar, residuary product of oil or any refuse of any kind from any well or works shall be permitted to be deposited on or pass into the waters of the ocean or any bay or inlet thereof. (New provisions are italicized.)

Statutes of California, 1955, Chapter 1724.

Sec. 22. Section 6873 of the Public Resources Code was amended to read:

Form of Lease: Preparation: Contents.

When leasing tide or submerged lands, the commission shall prepare a form of lease which shall contain, in addition to other provisions deemed desirable and necessary by the commission, appropriate provisions contained in this chapter and the following:

(a) Each well drilled pursuant to the terms of the lease may be drilled or slant-drilled to and into the subsurface of the tide or submerged lands covered by the lease from upland or littoral drill sites owned or controlled by the State or owned by or available to the lessee, or from drill sites located upon any filled lands heretofore or hereafter filled, whether contiguous or noncontiguous to the mineral land or uplands, or from any piers heretofore or hereafter constructed, owned by or available to the lessee and available for such purpose, or from platforms or other fixed or floating structures in, on or over the tide or submerged lands covered by the lease or available to the lessee.

Also added by Stats. 1955, Chapter 1724, Secs. 6 and 23 was the following.

Section 6873.1 reading as follows:

Filled land. Filled lands should include, but not be limited to, tide or submerged lands, reclaimed artificially through raising such lands above the highest probable elevation of the tide to form dry lands, by placement of a fill or deposit of earth, rock, sand or solid imperishable material. Such fill may be retained in place or protected by bulkheads, seawalls, revetments or similar enclosures and may be placed at any location approved by the commission under a lease heretofore or hereafter issued pursuant to this Article.

The Official Report of Proceedings before the Tax Court of the United States (page 28) contains the following questions and answers asked of and given by Leonard Graves, a witness called on behalf of the respondent, Southwest Exploration Company:

"Q. Does Standard Oil Company have any restrictions on the distance of the bottom of your well from the mean high tide line? A. We have to stay 200 feet away from the mean high tide line, offshore from the mean high tide line.

Q. Have all of the Petitioner's wells conformed to that restriction? A. They have.

Q. Are those so-called uplands on which you have the tops of your wells used for any other purpose? A. Standard Oil Company has wells on that property, on [page 29] those properties.

Q. I will broaden my question not only to the question that you have the tops of your wells, but also did

you go through to the ocean? A. Yes, sir, they had Standard Oil wells on these properties.

Q. Properties owned by the Huntington Beach Company? A. That is right.

Q. And by the Pacific Electric Land Company? A. Yes.

Q. Is Standard Oil producing oil from the uplands? A. They are.

Q. Are those vertical wells? A. They are.

Q. What was the date of the first well drilled by Standard on those uplands? A. 1923; referring to the map that you had of the wells nearest to the Southwest wells, 1923 was the first well drilled [page 30] in that area.

Q. Are tideland oil deposits ever drilled and operated except from the use of uplands such as is done in this case? A. Yes, sir.

Q. In what other way are they drilled and operated? A. They have been drilled from piers and filled lands on the tidelands, and barges.

Q. Just one more question, then. Prior to 1938 did the State of California permit state lessees and operators to develop and operate tideland oil deposits from piers, islands or barges? A. Yes, sir, there are piers at several places along the coast, like Rincon, Ellwood and Summerland.

[Page 34] Q. Mr. Graves, if the law were changed to permit it, could not Petitioner even now develop this property and operate this property from fills, barges or piers? A. If the law were changed, that would be a very possible way to do it and it would be very desirable."

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No.

286

IN THE

Supreme Court of the United States

October Term, 1955.

No. 286.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

SOUTHWEST EXPLORATION COMPANY, a corporation,

Respondent.

Upon Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

SUPPLEMENTAL BRIEF FOR THE RESPONDENT.

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SUPPLEMENTAL BRIEF FOR THE RESPONDENT.

Statement.

This supplemental brief is solely in response to arguments made by Huntington Beach Company, a corporation, Respondent in Case No. 287 entitled "The United States of America, Petitioner, vs. Huntington Beach Company, a corporation, Respondent" wherein Huntington Beach Company is claiming depletion deductions on the rent it received from Southwest Exploration Company for the use of drilling sites belonging to Huntington Beach Company and used by Southwest Exploration Company in the development and operation of its California State Tideland Lease No. 392.

Since the United States of America and the Huntington Beach Company have taken the same sides of the case in which Southwest Exploration Company is interested, No. 286, Southwest Exploration Company assumes that it is appropriate that it have an opportunity to reply to the brief filed by the Huntington Beach Company, especially since Southwest Exploration Company will not have an opportunity at the hearing to reply to the oral arguments made by counsel for Huntington Beach Company.

ARGUMENT.

The Reply Brief of Southwest Exploration Company answered most of the points made by Huntington Beach Company in its brief in Case No. 287, and as to those points Southwest Exploration Company will not repeat the arguments made in its brief in Case No. 286.

I.

The Upland Drill Sites Produced No Income Subject to Depletion.

On pages 7 and 8 of their brief, counsel for Huntington Beach Company argue that the uplands constitute a part of the mineral property subject to depletion, within the specific definition of the Treasury Regulations construing the depletion provisions of the Internal Revenue Code. On page 8 they quote from Regulations which they claim show that the property, the income of which is subject to depletion, includes "the mineral deposits, the development and plant necessary for its extraction and so much of the surface of the land only as is necessary for purposes of mineral extraction."

They argue that the upland is the surface necessary for the purposes of mineral extraction from the tideland

lease, and that the rental income their surface produces for them, from Southwest Exploration Company, is thus subject to depletion deductions.

Southwest submits that this interpretation of the Regulations is not valid for the following reasons:

1. The use of the uplands as a drill site was not *necessary* for the purposes of mineral extraction from the State Lease. Southwest could *physically* have developed its State Lease from piers, barges, filled lands or fixed structures over the water.

2. The word "property" as used in the Statute, Section 114(b)-3, means oil and gas wells, not mineral property or plant and surface of the land. That section reads:

> "In the case of *oil and gas wells* the allowance for depletion under Section 23(m) shall be 27½% of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *" (Emphasis supplied.)

That the word "property" thus means oil and gas wells is shown by Regulations 111, Section 29.23(m)-1 which reads as follows:

> "Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, *oil and gas wells*, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the basis upon which depreciation and depletion are to be allowed.
>
> "Under such provisions, the owner of an economic interest in *mineral deposits* or standing timber is allowed annual depletion deductions. * * *" (Emphasis supplied.)

Throughout the definition in the Regulations of depletable interests, the language used is "mineral deposits" or "mineral in place" and the word "property" is not used.

3. Regulations 111, Section 29.23(m)(1)(c) clearly implies that only the mineral deposit is depletable. That section reads:

> 'The term 'mineral deposit" refers to minerals in place. The cost of the *mineral deposit* is that proportion of the total cost of the *mineral property* which the value of the *deposit* bears to the value of the *property* at the time of its purchase." (Emphasis supplied.)

4. The term "mineral property" as defined in Regulations 111, Section 29.23(m)-1(b), (partially quoted by counsel for the Huntington Beach Company), has a purpose other than that of defining a depletable interest. The real purpose is to limit the depletion deduction as required by the last sentence in Section 114(b)(3) of the Code which reads:

> "Such allowance shall not exceed fifty percentum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23(m) be less than it would be if computed without reference to this paragraph."

The last quoted clause means that the taxpayer has the choice of taking "cost" depletion deductions on one property and "percentage" depletion deductions on another property. On the properties where the taxpayer choses to take percentage depletion, he must compute the gross income from the property, the expenses of operating the property and the net income from the property. Con-

sequently, it was necessary for the Commissioner, in the Regulations, to define "mineral property", so that the taxpayer and the Commissioner would know how to allocate the income and expenses between properties. To achieve that object, he promulgated Regulation 111, Section 29.23(m)(1) which, in its full context, reads as follows:

> "'The property', as used in Section 114(b)(2), (3) and (4) and Section 29.23(m)-1 to 29.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. The taxpayer's interest in each separate mineral property is a separate 'property'; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single 'property', provided such treatment is consistently followed."

Note the emphasis on the word "separate" used twice in the above quoted Regulations.

Consequently, there was no intention in the Regulations to promulgate a rule that the gross income from an "oil or gas well" comes in part from the mineral deposit and in part from the surface of the land and from the plant. Expenses relate to the plant and surface but the gross income comes only from the sale of oil and gas produced from the mineral deposit.

The proposition that the surface of the land produces income from a natural resource subject to depletion is answered on pages 23, 24 and 25 of the brief for the respondent, Southwest Exploration Company, Case No. 286, and will not be repeated here, except to add that in *Grunsboro Gas Co. v. Commissioner*, 30 B. T. A. 1362, 1369, the Board of Tax Appeals said: "Clearly Congress

had no intention of allowing the percentage depletion on anything except a natural resource itself."

The interpretation given to the Regulations by Southwest in this brief is borne out by the provisions of the Internal Revenue Code of 1954. Section 614 of the Internal Revenue Code of 1954 has a definition of "property" as used in subchapter (I) dealing with Natural Resources under the 1954 Code. Section 614 reads, in part, as follows:

> "a. General Rule: For the purpose of computing the depletion allowance in the case of mines, wells and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each *mineral deposit*, in each separate tract or parcel of land." (Emphasis supplied.)

Section 614 then makes special rules for computing the gross and net income of mineral property and under certain conditions allows several mineral properties to be aggregated.

As to this section, the Senate Finance Committee Report No. 1622 on H. R. 8300, page 80, 83rd Congress, 2nd Session said in part:

> "Although depletion allowances are computed with respect to mineral properties, present law does not define a 'property.' In general administrative regulations state that each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land constitutes a property. From the standpoint of both taxpayers and administrators, however, this division of properties creates difficulties because, in some instances, it requires the preparation of multiple depletion schedules and computations where a single computation would serve the same purpose.

"The House bill clarifies the situation with respect to depletable properties by adding a statutory definition of 'the property.' This provision adopts as the general rule the same definition relating to separate interests now established by regulations. In addition, however, the new provision permits a taxpayer to elect for purposes of percentage depletion to treat as one property an aggregation of his separate mineral interests which constitute all or part of an operating unit."

5. Finally, if the surface of the uplands is a portion of any mineral property, it is the portion of the mineral property which is leased to the Standard Oil Company by the upland owners. If the Regulation has any semblance of the point for which Huntington Beach Company cited it, it was intended for the general situation where the surface involved was the surface covering the mineral deposit, not the very extraordinary case involved in the case at bar. The question may again be put—of how many properties can this surface be a part?

II.

Authors of Technical Articles Support Both Sides to the Argument.

On pages 9 and 10 of their brief, counsel for Huntington Beach Company, in footnotes, quote articles or editorials appearing in the Oil and Gas Tax Quarterly, No. 60 (October, 1952), and in Report of the Committee on Natural Resources, American Bar Association, Section of Taxation, Program, and Committee Reports, presented at the Sixteenth Annual Meeting, August 18 to 24, 1955, Philadelphia, Pennsylvania, pages 80 and 81; and in Merten's Law of Federal Income Taxation, 1954 Edition, Volume 4, Section 24.25(a), Note 10.

Those articles and comments base their criticism of the ax Court decision in the Southwest Exploration Com- ıny case largely on the point that the upland owners ıd made a contribution; in other words, they had a ›st for their rental contract. But they overlooked the ıct that in *Helvering v. O'Donnell*, 303 U. S. 370, and *'elvering v. Elbe Oil Land Company*, 303 U. S. 372, the ıxpayers there who were denied depletion deductions also ıd costs for their rights to shares of net profits, which ghts were even more closely connected with the property ıan a right to receive rent measured by a share of net rofits.

The decision of the Tax Court in the *Southwest Explo- ıtion Company* case, 18 T. C. 961, has its supporters so. In the Oil and Gas Reporter, issued by the South- estern Legal Foundation, Volume 1, page 1500, the Tax ourt decision in the *Southwest Exploration Company* ıse, 18 T. C. 961, is discussed. In this question of de- etion the publication says:

"2. Depletion: Who May Take, on Percentage of Net Profits Payments.

"Since the decision in *Burton-Sutton Oil Co. v. Commissioner*, 325 U. S. 25 (1946), we generally say that the holder of the net profit interest is entitled to depletion thereon. In so doing we may thereby tend to forget the underlying rationale and become careless in defining the term net profits interest. In the principal case the payment of 24½% of the producer's net income for the right to place drilling rigs on the uplands would seem at first blush to give the owners of the uplands a net profits interest which would deprive the producer-taxpayer of the depletion thereon. However, it is submitted that the rule of Burton-Sutton applies only in situations in which the holder of the net profits interest is one who

held another economic interest which he surrendered in the course of acquiring the net profits interest. That is not to say that the rationale of Burton-Sutton would preclude one from ever acquiring his initial economic interest in an oil property in the form of a net profits interest. (It might be done by deliberate action in which it was carefully spelled out that the producer was disposing of all right, title and interest in and to a portion of his economic interest, the portion to be measured by a percentage of net profits.) However such an acquisition would be most unusual. Under the circumstances of this case it therefore appears the court was fully justified in finding that the taxpayer was the owner of the entire economic interest (subject to the State's royalty interest); and that the payment to the upland owners was nothing more than rental for the use of their land, the test being measured by a percentage of the taxpayer's net profits."

The editorials or articles cited by counsel for the Huntington Beach Company in their brief are further examples of situations where lawyers and others may make the mistake of following general expressions or general discussions in decisions instead of following the holdings based upon the facts involved in the cases being used as precedents.

The footnote at the bottom of page 11 in the brief of Huntington Beach Company contains a comment from Merten's Law of Federal Income Taxation, 1954 Edition, Volume 4, Section 24.25(a), Note 10. This note says:

"The taxpayer will presumably be entitled to deduct the payments made to the upland owners as ordinary and necessary business expenses, thus receiving a double tax benefit."

There is nothing surprising in that suggestion as every oil lessee is entitled to take percentage depletion deductions on the gross income from the property (after excluding the royalties paid to the landowner) and then to deduct intangible drilling expenses, taxes, depreciation and all the other expenses of operating a property. It should be noted, however, that the percentage depletion deduction is limited to 50% of the net profits remaining after deducting all these actual expenses. Consequently, the allowance to Southwest Exploration Company of percentage depletion on the amount of rental it paid to the Huntington Beach Company up to the 50% limitation, and its allowance of a deduction for the rent paid, would not be unusual. After all, a percentage depletion deduction merely takes the place of a cost depletion deduction which would be allowable without limitation, in addition to the other expenses.

III.

The California State Lands Act of 1938 Gave the State Control Over the Uplands to Stop Drainage From Upland Wells.

On pages 4 to 7, inclusive, of their brief, counsel for the Huntington Beach Company argue that from the outset it had "direct control" over the production of the oil and gas from the State Tideland Lease belonging to Southwest Exploration Company. It bases this claimed control under the State law and the terms of the State easement. It argues that grants from the State and from the Huntington Beach Company were necessary to obtain the right to produce.

They, therefore, base their principal case (as does the Government) on the proposition that the California State

Lands Act of 1938 put the upland owners in a position of control over the development of the State's tideland oil resources.

This is exactly the opposite from the purpose and effect of such California legislation. As will be seen hereinafter, the purpose of the California Lands Act of 1938 was to give the State control over the uplands for use as a facility in developing the tideland resources of the State in order to protect the State from drainage by the upland owners.

Under the California Statute in effect (Stats. 1921, Sec. 4, p. 404), prior to the 1938 enactment, California officials were permitted to give exploratory permits for drilling only on areas not known to be geological structures.

Section 4 of the Act of 1921 above referred to reads in part as follows:

> "The Surveyor General is hereby authorized, upon the payment to him of 50¢ per acre, for each acre in area embraced within the boundaries of the lands proposed to be prospected and under such rules and regulations as he may prescribe, to grant to any person or association of persons, who are residents of the State of California and citizens of the United States or who have declared their intention of becoming such, or corporations 90% of whose stockholders are citizens of the United States, a prospecting permit which shall give the exclusive right, for a period not exceeding two years, to prospect for oil or gas, upon not exceeding 640 acres of land *wherein such deposits of oil or gas belong to the State and are not within any known geological structure of a producing oil or gas field*, upon condition that the permitee shall begin drill-

·ing operations within six months from the date of the permit, and shall within one year from and after the date of the permit, drill one or more wells for oil or gas to a depth of not less than 1000 feet each, unless valuable deposits of oil or gas shall be sooner discovered, and shall, within two years from the date of the permit, drill for oil or gas to an aggregate depth of not less than 2000 feet unless valuable deposits of oil or gas shall be sooner discovered." (Emphasis supplied.).

y 1938 upland owners and their lessees had drilled y vertical wells along and close to the shore line of fornia. Many of these wells were draining the e's adjoining tideland oil resources. The State, ever, was powerless to put a stop to this drainage. h incidental drainage as there might be was lawful er the applicable case law. (*Ohio Oil Co. v. State of ana*, 177 U. S. 190, 211.) The State could not grant exploratory permit on the tideland reserves and cause permittee to drill offset wells, because the area was a wn geological structure, so proven by the upland wells.

n order to put the State in position to stop this drain- the State Lands Act of 1938 was enacted. It au- ized the appointment of a State Lands Commission ch was given authority to lease known geological ctures where, but only where, it was thought that nage was taking place from the State's mineral re- rces. The Legislature wished to avoid pollution of beaches so it required that wells on State tideland es be drilled from filled lands or uplands.

n order to give the State Commission adequate power fulfill the two purposes of preserving the State's eral resources and doing it in a manner that would

despoil the beaches, it gave the State Commission hority, in Section 40 of the State Lands Act of 1938 ppx., Resp. Br. p. 4), to condemn the uplands or hts of way therein, or to lease them, and to pay an quate consideration for such rights, and to turn them r to the State lessee.

The area under consideration in this case near Hunt-ton Beach, California, was one where at least eleven and wells had been drilled by Standard Oil Company, lessee for the upland owners, which were close to the ore and were thought to be draining the State's re-urces. There were no filled lands in that immediate at that time. (It would have been possible under 1938 Act for a lessee to have made an island by ing, from which it could have drilled in compliance th the State law. (9 Opinions of Attorney General lifornia, p. 299, June 12, 1947; *Monterey Oil Com-ny v. City Court of City of Seal Beach*, 120 Cal. App. 31.). But this method was not chosen by the Com-ssion at that time.)

The State Lands Commission, therefore, determined use the littoral uplands to develop the State's resources d cause eleven offset wells to be drilled in order to stop drainage by the upland owners. Therefore, the Com-ssion in advertising for bids for the lease, specified that hts of way be obtained from the littoral upland owners. e Commission thus decided to give the upland owners hance to make a voluntary arrangement for the rental their drill sites rather than to condemn the drill sites the first instance.

Had the upland owners, however, been so unreasonable their rental demands that no applicant for the State

e would agree to their terms, no one would have bid the State Lease on the area involved. The State ls Commission would not have allowed the upland ers to thwart the State, but would have condemned upland or a right of way therein, paid the upland ers for the value of the rights taken, in cash, not ndent in any way upon production or income from the e's tidelands. The lack of a depletable interest in such eeds when received by the upland owners would have altogether clear.

the alternative, the Lands Commission could have ved the use of filled lands for developing the State e. If this method had been followed, and the State ve exhausted therefrom, what depletion would the nd owners have suffered?

nsequently, it is obvious that the State Lands Act of placed the State in control of the uplands for use facility in developing the State's tideland resources, r than placing the upland owners in a position of ol over the development of the State's tideland re- ces.

mediately upon obtaining the lease, Southwest drilled required eleven offset wells, thus stopping the drain- f the State's off-shore oil deposits by the eleven wells ously drilled by the upland owners along or close e shore line of California.

decision by this Court that the upland owners have onomic interest in the oil in place in the tideland oil ve would violate the following:

The written agreement of the upland owners that they have no such interest. [Ex. 9-I, par. 13; R.

2. The State Lease No. 392, which provides that no assignment of the lease or portions thereof shall be valid without the written consent of the State Lands Commission. No such consent was requested or obtained. [Ex. 5-E, Sec. 2-N; R. p. 35.]

3. The California State Lands Act of 1938, Section 31 (Appx. 3, 4), which prohibits sale of State owned mineral deposits and only permits their leasing on a royalty basis. The upland owners did not lease on a royalty basis any interest in State Lease No. 392.

4. The California Constitution, Article IV, Section 31 (Appx. 3), which prohibits the Legislature from making gifts of anything of value. Hence the State Lease could not have made the upland owners co-lessors with the State.

5. The reasonable interpretation of the purpose of the State Lands Act of 1938. Where the Legislature was motivated by a desire to protect the State's tideland oil reserves from drainage by upland owners' wells, it is not likely that the law would have vested in the upland owners the right to continue that drainage or to receive greater rights therein. The reasonable expectation is that the law would give the Lands Commission adequate power to do everything necessary to achieve the object of the legislation—namely, to terminate the upland owners' interest, through drainage, in portions of the State's oil.

IV.

The Upland Owners Had No Control Over Production. They Merely Had Some Regulation Over the Use of the Uplands.

On page 6 of their brief, counsel for Huntington Beach Company argue that the upland owners "reserved significant elements of control over production."

But the matters referred to on page 6 related to the joint use of the surface and subsurface of the uplands, by Southwest and by Standard Oil Company and were necessary to prevent the operators from injuring each others' wells, pipes, casings and equipment; also to enable the upland owners to detect whether Southwest was drilling into the upland reserves or reserves other than in State Lease 392.

The regulation of the use of the uplands only related to drilling, and the physical condition of the wells, and not to production from the wells. On this matter, the upland owners had no voice.

Conclusion.

For the reasons stated above and for the reasons set forth in the principal brief filed by Southwest Exploration Company in Case No. 286, the decision of the Court of Appeals should be affirmed.

Dated: January 18, 1956.

Respectfully submitted,

MELVIN D. WILSON,
Counsel for Respondent.

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4952

MATTHEW BENDER & COMPANY MB 55

Petition for a Writ of Certiorari

No. 287

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HAROLD B. WILLEY, Clerk

In the Supreme Court of the United States

OCTOBER TERM, 1955

THE UNITED STATES OF AMERICA, PETITIONER

v.

HUNTINGTON BEACH COMPANY, A CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

SIMON E. SOBELOFF,
Solicitor General,
H. BRIAN HOLLAND,
Assistant Attorney General,
ELLIS N. SLACK,
HILBERT P. ZARKY,
Attorneys,
Department of Justice,
Washington 25, D. C.

No. —

THE UNITED STATES OF AMERICA, PETITIONER

v.

HUNTINGTON BEACH COMPANY, A CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The Solicitor General, on behalf of the United States, prays that a writ of certiorari issue to review the judgment of the United States Court of Claims entered in this case.

OPINIONS BELOW

The findings of fact, conclusion of law and opinion of the Court of Claims and the concurring opinion of Chief Judge Jones (Appendix, *infra*, pp. 5-30) are not yet reported.

JURISDICTION

The judgment of the Court of Claims (Appendix, *infra*, p. 30) was entered on July 12, 1955.

uthwest Exploration Company obtained a
from the State of California to drill for and
nce oil from certain submerged lands. By
law, Southwest was required to drill the wells
slant from uplands adjacent to the coastal
and, as a condition to obtaining the lease, was
iréd to secure necessary easements from the
nd owners permitting it to conduct the drilling
production operations from and through their
erty. In return for securing such easements
certain upland owners, of which taxpayer
one, Southwest undertook to pay them 24½
ent of its net profits derived from the extrac-
of oil from the submerged lands.

ie question is whether taxpayer is entitled to
entage depletion on the portion of South-
's net profits which it received, as was held
he court below, or, on the contrary, whether
hwest is entitled to depletion on those payments
ie exclusion of taxpayer, as was held by the
rt of Appeals for the Ninth Circuit in a com-
on case involving Southwest.

STATUTES AND REGULATIONS INVOLVED

ne applicable statutes and regulations (Sec-
s 23 (m), 114 (b)(3) of the Internal Revenue
e of 1939, Sections 6873 (a) and 6874 of the
lic Resources Code, Deering's California Codes
4), and Section 29.23(m)-1 of Treasury Regu-

oner v. *Southwest Exploration Co.*, in which
ition for a writ of certiorari is being filed, and
are set forth in Appendix A of the petition
at case.

STATEMENT

e essential facts in this case are identical with
in *Commissioner* v. *Southwest Exploration*
nd are set forth at pages 3-9 of the petition for
t of certiorari filed in that case.

xpayer in this case is one of the upland owners
during the taxable year 1948 received from
hwest Exploration Company the sum of $1,298.
5, representing 17.75 percent of Southwest's
rofits from the oil properties in question. In
ax return, taxpayer claimed a deduction for
entage depletion on this amount. The District
ctor of Internal Revenue disallowed the deduc-
and proposed additional income taxes of
664.29. Taxpayer paid the additional tax,
interest, and thereafter filed a claim for re-
. After denial of the refund claim by the Com-
ioner of Internal Revenue, taxpayer brought
action in the Court of Claims. The Court of
ms held that taxpayer was entitled to the
ned deduction and to recover the additional
s and interest which it had paid, together with
utory interest on those amounts.

REASONS FOR GRANTING THE WRIT

e reasons for granting the writ in this case
identical with those set forth in the petition
a writ of certiorari filed in *Commissioner* v.

referred to the petition in that case for
n of the reasons which make it equally
e that the petition be granted in this

CONCLUSION

pectfully submitted that the petition for
ertiorari should be granted.

SIMON E. SOBELOFF,
Solicitor General.
H. BRIAN HOLLAND,
Assistant Attorney General.
ELLIS N. SLACK,
HILBERT P. ZARKY,
Attorneys.

1955.

IN THE UNITED STATES COURT OF CLAIMS

No. 18-55

(Decided July 12, 1955)

HUNTINGTON BEACH COMPANY, A CORPORATION

v.

THE UNITED STATES

OPINION

MADDEN, *Judge*, delivered the opinion of the urt:

The plaintiff owned land near the seashore in alifornia. It granted to Southwest Exploration ompany the right to come on its land and drill ells slantwise to reach oil deposits which were eath the adjoining submerged lands owned by e State. As compensation, Southwest greed to y the plaintiff 17.75% of Southwest's net profits om the sale of the oil taken from the wells. Dur- g the year 1948 the plaintiff received large sums money from Southwest under this arrangement. claimed, but the Commissioner of Internal Rev- ue denied to it, the right to a depletion deduction those receipts, under sections 23(m), 53 Stat. 14, d 114(b), 53 Stat. 45, of the Internal Revenue ode of 1939. It paid its corporate income taxes thout the benefit of the deduction, and here sues r the refund of $182,802.98 of taxes and interest

which it paid, and for interest on that sum as provided by law.

When the owner of solid minerals or of oil and gas deposits receives money as a result of the mining or production of these commodities, what he receives is treated, for tax purposes, as income, and not as a return upon the sale of a capital asset. But the income is different from interest or rent in that the production of the income depletes the source from which the income is derived. For this reason the tax statutes permit the receiver of such income to deduct, in his tax return, 27½% of his gross income from the production of oil.

When the oil produced or the income from its production is, by the arrangements of the parties, to be divided among two or more persons, the basic reason for the depletion allowance is applicable to each of them in his proper proportion. In the usual arrangement whereby the landowner is to have one-eighth of the oil and the operator is to have seven-eighths, the prospect of each for future receipts is diminished as present receipts are obtained. Section 23(m) of the Internal Revenue Code says that in the case of leases the depletion deductions shall be equitably apportioned between lessor and lessee.

Transactions looking to the production of oil and gas have taken a great variety of forms. The landowner leases, reserving a royalty. The lessee may sublease, reserving a royalty. Or he may "assign" his lease; the assignee promising to pay a

consideration only out of oil produced, and measured by the amount of production. These are only simple illustrations of the various forms which such transactions take. The statutes do not specifically provide for the application of the depletion allowance to these various forms of transactions. But the Supreme Court of the United States has decided many cases involving the depletion allowance, and has thereby developed principles helpful in the solution of other cases not covered by that Court's decisions.

Southwest Exploration Company, the operator which produced the oil from wells on the plaintiff's land, claimed the depletion deduction on all of the oil income. The plaintiff, at the same time, claimed the deduction on its 17¾% of Southwest's net profits. In order to protect the revenue against the loss which would result if these competing claims to the same deduction were both successful, the Commissioner of Internal Revenue took inconsistent positions and denied the disputed portion of the deduction to both parties. Southwest contested the Commissioner's denial in the Tax Court, and that court held in *Southwest Exploration Co.* v. *Commissioner*, 18 T. C. 961, that the plaintiff did not possess a depletable interest and that Southwest was entitled to the deduction on all its gross income from the oil wells during the years 1939 through 1945. The United States Court of Appeals for the Ninth Circuit, in a per curiam opinion affirmed, on the basis of the Tax Court's opinion. *Commissioner* v. *Southwest Exploration Co.*, 220

annot prevail in this case. It is not legally permissible for both companies to have the same deduction.

The fact that in the instant situation the plaintiff received a share in the net profits from the production of oil, rather than a share of the oil produced regardless of the expense of production, is not a reason to deny the plaintiff a depletion deduction. In *Kirby Petroleum Co.* v. *Commissioner*, 326 U. S. 599, a landowner leased his land for the production of oil and gas in return for a cash bonus, a fractional royalty, and 20% of the net profits realized from the production. The Court held that the lessor was entitled to a depletion deduction on the percentage of net profits payment, as well as on the bonus and the royalty. The Court held that the net profits provision gave the taxpayer an additional economic interest in the oil. The Court, at page 603, said:

> By this is meant only that under his contract he must look to the oil in place as the source of the return of his capital investment. * * * The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necesarily reduced as the oil is extracted.

The Court, at page 604, further said, in explaining why no distinction was to be made between a retained royalty interest in gross production, and in the operator's net profits:

> In both situations the lessors' possibility of return depends upon oil extraction and ends with the exhaustion of the supply. Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of oil.

In the language from the *Kirby Petroleum* case first quoted above, the reference to the taxpayer's "capital investment" in the oil in place should be noted. It surely cannot mean that it would make any difference that the land had been bought by the lessor for a song as practically worthless desert land, and with no thought of the possibility that it might be a source of oil. In *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, 34, the Court said:

> The cost of that investment to the beneficiary of the depletion under § 114(b)(3) is unimportant. * * * Through retention of certain rights to payments from oil or its proceeds in himself, each of these assignors of partial exploitation rights in oil lands has maintained a capital investment or economic interest in the oil or its proceeds.

It is apparent that in the Supreme Court's view, the economic interest is the essential thing, regardless of what, if anything, it cost to acquire it.

In the *Burton-Sutton* case, *supra*, the question was whether one G, who was in a chain of title

rom the original lessor, but who had in turn trans-
erred his rights to another, who had transferred
s rights to an operator under a contract requiring
e operator to pay 50% of the profits of the opera-
on to G, was entitled to the depletion deduction.
he Government, in arguing against the deduc-
on, urged that the decision in the *Kirby Petro-
um* case, *supra*, was based on the fact that the
xpayer there had, in addition to his right to a
ercentage of profits, a right to an oil royalty and
bonus. The Government urged that a right to
percentage of profits, standing alone, should not
ntitle the taxpayer to the depletion deduction.
he Court rejected that argument and said at page
2:

> We do not agree with the Government that ownership of a royalty or other economic interest in addition to the rights to net profits is essential to make the possessor of a right to a share of the net profit the owner of an economic interest in the oil in place. The decision in *Kirby* did not rest on that point.

We must, then, determine the nature and extent
f the plaintiff's economic interest in the oil from
hich it derived the income here in question. Un-
er the California law the oil under the State's
ubmerged lands could not be recovered except by
rilling in the upland. As a condition precedent
o obtaining a lease from the State to drill for oil,
n operator had to obtain the consent of the owner
f the upland to such drilling. The plaintiff owned

fr net profits." That would seem to me
ae plaintiff, far from being a stranger, y
as intimately related to the oil as is the
landowner on whose land vertical drill
be done. An oil operator does not g
ers a percentage, large or small, of his
. In this case the plaintiff was in such
nd geographical position of control with
o the oil under the State's submerged lan
could, and did, in exchange for its cons
recovery of the oil, require that it be p
of the operator's net profits, which, in
year 1948, brought a payment to the pla
$1,298,222.85.

pose A owns land in fee simple. He gra
olf club an easement to use the surface
d for a golf course. Oil is discovered in
orhood. A grants to C the oil in the fa
ing a royalty. But C cannot drill upon
ince to do so would be incompatible with
ent of the golf club. The golf club grants
right to drill upon the land, in return to

its land, and its prospects for future return
minish as the oil was taken out. In all
he plaintiff had an economic interest in the
feature that makes this case unique, the
the drilling was done slantwise instead
ally, is surely immaterial.

ases in which the Supreme Court has held
taxpayer claiming the depletion deduction
ave the required economic interest are dis-
ible. In *Helvering v. Elbe Oil Land Co.*,
372, the taxpayer, the owner of oil land,
r a fixed consideration, part of which was
nce and the balance payable in succeeding
the purchaser should not elect to abandon
saction. In addition, the vendor was to
ne-third of the net profits which the trans-
ght earn after having been fully reim-
r its expenditure in the acquisition, devel-
and operation of the property. The money
the taxpayer sought the depletion deduc-
the fixed sum payments it had received.
rt held that the money was income from
of the oil and gas properties themselves,
income from the operation of wells on
erty.

lvering v. *O'Donnell*, 303 U. S. 370, the
ld that a taxpayer who had transferred
corporate stock to an operating company
for its promise to pay him one-third of
profits of its oil operations on certain prop-

him to the depletion deduction. The taxpayer there, unlike the plaintiff in the instant case, had no relation to or control over the production of the oil before he bought and paid for a right to share the profits. He was, factually, and legally, a stranger to the oil property.

In *Anderson* v. *Helvering*, 310 U. S. 404, the taxpayer purchased, for a fixed consideration certain royalty interests, fee interests, and oil payments in designated properties. He paid a part of the consideration in cash, and promised to pay, on the balance, one-half of the proceeds of oil and gas produced from the properties, and one-half of his receipts from the sale of the fee properties. During the taxable year, the taxpayer received income from the production of oil and gas, and paid one-half of it over to his vendor. He sought to exclude these payments from his taxable income. The Court held that he could not do so. If the transferor had been entitled to be paid only out of oil and gas production, it would have continued to have an economic interest in the property. But since it was entitled to be paid also from the sale of the fee interests, the transaction was a sale to the vendee taxpayer and the payments which he sought to exclude from his income were payments on the purchase price.

In *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, the taxpayer had contracts with oil producers to separate the wet gas from the dry gas as it flowed from the wells, thereby producing casinghead gasoline. The taxpayer was to keep two-thirds of the

oect to its income from these contracts. The
rt denied the claim. It said that through its
tracts the taxpayer obtained an economic ad-
tage from the production of the gas, but that
ad no interest in the gas in place. It would
n that the taxpayer in that case was in a situa-
comparable to one who has a contract to buy
r gas from producers at the wells, for the pur-
e of reselling it at a profit. As production falls
his resales and profits will fall off. But his
tion to the production is merely collateral.
ore he made his contract, he had no relation
he oil, factual or legal. His contract gave
only somewhat the same kind of an interest
continued production which employees, mer-
nts, homeowners, and others in an oil producing
have in continued production.

or a landowner to have a degree of control over
t may be done on neighboring land is not un-
al. There is a large body of law relating to
in alieno solo. The recognized natural rights
ight and air, lateral support, and the flow of
ams exist merely by reason of physical location.
ements, affirmative and negative, are created
grant or by prescription. Restrictive covenants,
rly always negative in nature, are recognized
enforced in equity. All of these are interests,
t of ownership, in the land whose use is affected
hem. Because of the applicable law, and the
tion of the plaintiff's land, its economic interest

in the oil here in question was just as real and just as legally well-grounded as those in the ordinary cases of rights in the land of another.

Our conclusion is that the plaintiff had an important economic interest in the oil under the State's submerged lands, by reason of its control over the recovery of the oil; that it could have surrendered its control by an outright sale, but instead took in exchange a share of the possible net profits; and that the reasons on which the depletion allowance is based are present in the plaintiff's situation. We will therefore award the plaintiff a judgment for $182,802.98, with interest according to law.

It is so ordered.

LARAMORE, *Judge*; WHITAKER, *Judge*; and LITTLETON, *Judge*, concur.

JONES, *Chief Judge*, concurring:

I concur in the foregoing opinion, but with the following added comment:

Ordinarily only the owner of the land in which the oil is located or his assignee has any control over the production of the mineral, and consequently any interest in its extraction from the soil. But here the contracts are conditional and interwoven.

The State of California is the owner of the mineral and the land in which it is found.

If the State, as owner, had made an unconditional lease the economic interest would have been confined to the owner, or the lessee of any subse-

quent assignee of any interest or part interest from either of them.

But this was a conditional assignment. The only economic interest the lessee could possibly have was the right to extract and sell oil. To make his contract effective and give it any value or interest whatever, it had to be linked to a contract with plaintiff. Otherwise it would have no life and no value. The State law so provided. The contracts were thus tied together and became a part of the warp and woof of the same garment. Neither of the contracts standing alone was effective.

It took the second contract, that with plaintiff, to make the transaction complete. The two contracts were each part of a larger and more comprehensive contract without which no operations could even have been started. If the maker of one essential contract has no economic interest the maker of the other has none.

WHITAKER, *Judge*, also joins in this concurring opinion.

FINDINGS OF FACT

The court, having considered the stipulation of facts entered into between the parties, and the briefs and argument of counsel, makes findings of fact as follows:

1. Plaintiff is a corporation duly organized and existing under the laws of the State of California. Its principal office is located at San Francisco, California.

2. On or about May 31, 1949, plaintiff duly filed with the Collector of Internal Revenue, First District of California (subsequently designated as District Director of Internal Revenue, San Francisco, California, and herein sometimes referred to as Collector), its corporate income tax return for the taxable year ended December 31, 1948, prepared in accordance with the accrual method of accounting.

3. Plaintiff's corporate income tax return for the taxable year ended December 31, 1948, disclosed ordinary net income in the amount of $1,298,703.91. In arriving at said amount of ordinary net income for normal tax and surtax purposes plaintiff deducted percentage depletion of $357,911.28 on account of payments of $1,298,222.85 received from Southwest Exploration Company, a corporation (hereinafter designated as Southwest).

4. In its corporate income tax return for the taxable year ended December 31, 1948, plaintiff computed and disclosed its corporate income tax liability for such year in the total amount of $724,802.72. The amount of its Federal income tax liability as disclosed by its return was duly paid to the Collector and is not in controversy herein.

5. On December 13, 1950, the Internal Revenue Agent in Charge at San Francisco, California, acting on behalf of the Commissioner of Internal Revenue, proposed an additional income tax liability for the taxable year 1948 in the amount of $457.54. All of said amount of $457.54, together with interest thereon, was duly paid by plaintiff to the

Collector on February 21, 1951, and is not in controversy herein.

6. Upon subsequent audit and review of plaintiff's income tax return for the taxable year 1948, the District Director of Internal Revenue, San Francisco, California (formerly the Collector of Internal Revenue and hereinafter referred to as District Director), proposed additional income tax for the taxable year 1948 in the amount of $135,664.29. On December 30, 1954, plaintiff duly paid to the District Director all of said amount of additional tax of $135,664.29, together with statutory interest thereon of $47,138.69.

7. The additional income tax of $135,664.29 for the year 1948, as determined by defendant and referred to in the preceding paragraph, was based upon the disallowance of percentage depletion of $357,011.28 as claimed by plaintiff on the payments received by it from Southwest during the taxable year 1948 in the amount of $1,298,222.85 referred to in finding 3 above.

8. On January 3, 1955, plaintiff timely filed with the District Director a verified claim for refund of income tax for the taxable year ended December 31, 1948, in the amount of $135,664.29, plus interest thereon of $47,138.69, together with interest on said amounts as allowed by law.

9. In accordance with the applicable provisions of the Internal Revenue laws, the Commissioner of Internal Revenue notified plaintiff of the disallowance of its aforesaid claim by registered letter dated January 4, 1955.

10. In 1938 the State of California passed the tate Lands Act of 1938, now part of the Public esources Code dealing with the exploitation of oil eposits from the State tidelands. From August 1938, to August 13, 1938, the State Lands Commission published a notice entitled "Notice of Intention of State Lands Commission to Receive ffers to Enter Into an Agreement or Agreements for Extraction of Oil and Gas and Other ydrocarbons from Certain Tide and Submerged ands of the State Situate in Orange County, alifornia" (hereinafter referred to as the Notice).

11. The legal description in the Notice referred in finding 10 divided the land into five parcels, signated A, B, C, D, and E. Each parcel was id to contain 167 acres, more or less. The area tidelands and submerged lands identified in the iginal Notice as parcels A to E, inclusive, of said range County, California, tidelands and submerged lands constituted the entire area covered State Easement No. 392 which Southwest subequently obtained from the State of California the manner hereinafter set forth.

12. Southwest Exploration Company, a corporation (Southwest), is a corporation organized nder the laws of California and was incorporated June 20, 1933, but remained completely inactive ntil 1938. Its principal office is located at Los ngeles, California. Prior to the agreements dated ugust 25, 1938, hereinafter referred to, Southest did not own, lease operate or control any of

the uplands or littoral lands adjacent to the area referred to in the Notice and subsequently identified as State Easement No. 392.

13. Prior to the transmittal of its bid for State Easement, subsequently identified as State Easement No. 392, Southwest, as Permittee, entered into an agreement for a permit dated August 25, 1938, with Huntington Beach Company, a corporation, plaintiff herein, Pacific Electric Railway Company, a corporation, Pacific Electric Land Company, a corporation, Bolsa Land Company, a corporation, Bolsa Chica Gun Club, a corporation, and Standard Oil Company of California, a corporation, as Permittors. The lands of the Permittors referred to as uplands in the Notice and in the agreement, and more particularly described in the first "whereas" paragraph appearing on page 1 of said agreement constituted all of those lands referred to as littoral lands and uplands in section 1 of Agreement for Easement No. 392 and elsewhere therein, which are more particularly described in section 1 thereof.

14. On August 25, 1938, Southwest also entered into a second agreement with plaintiff and other upland owners setting forth in detail the procedures to be followed by Southwest in conducting operations from the uplands. Southwest was the only bidder for State Easement No. 392.

15. In accordance with the terms and conditions of the Notice, Southwest submitted its bid to the State Lands Commission on August 30, 1938. With its transmittal letter Southwest filed

with the State Lands Commission the following documents:

(a) Form of Agreement for State Easement, later identified as No. 392, with date omitted but signed by Southwest through its president and secretary; attached to the said Agreement for State Easement No. 392 were those portions of that agreement appearing at the end thereof entitled "Endorsement by Upland Owners," "Exhibit A (for entire tract)" and "Exhibit B;"

(b) The permit agreement referred to in finding 13;

(c) Cashier's check for $15,000 payable to the Treasurer of the State of California;

(d) Certified copy of resolutions authorizing Southwest's officers to execute the permit agreement and the agreement for easement referred to in finding 13;

(e) Certificate of ~~ownership~~ showing that all of Southwest's stockholders were residents of the State of California.

Southwest's bid conformed in all respects to the requirements of the State Lands Commission. Southwest furnished the $25,000 bond required by the Agreement for State Easement No. 392.

16. In accordance with the terms and provisions of the State Lands Act of 1938 (Cal. Stats. Ex. Sess. 1938, c. 5) Southwest's bid was accepted, and it entered into an Agreement for State Easement

No. 392 with the State Lands Commission on September 26, 1938.

17. There were no "filled lands" as that term is used in Article 6 of the State Lands Act of 1938 (Cal. Stats. Ex. Sess. 1938, c. 5) which were situated adjacent or contiguous to or otherwise usable or available in the extraction and exploitation of oil, gas or other hydrocarbon substances from the area constituting State Easement No. 392.

18. An agreement dated September 27, 1938, was made between Southwest, as party of the first part, and Huntington Beach Company, a corporation, Pacific Electric Railway Company, a corporation, and Pacific Electric Land Company, a corporation, as second parties. The agreement of September 27, 1938, supplements the prior agreements of August 25, 1938, between Southwest and the upland owners and provides a manner of computation of the amounts payable to plaintiff and other upland owners in consideration of the rights and privileges given by the upland owners to Southwest in the two agreements entered into on August 25, 1938, referred to in findings 13 and 14. Southwest entered into the agreement of September 27, 1938, with plaintiff and other upland owners in consideration of the rights and privileges granted to Southwest by the upland owners in the agreements of August 25, 1938.

19. Amendments to the Agreement for State Easement No. 392 were duly executed on December 6, 1938, and March 22, 1939, respectively.

20. All surface facilities and operations in connection with and for the drilling of and production of oil and gas from the wells covered by State Easement No. 392 and the tops of all such wells drilled pursuant thereto and in accordance with the terms of Southwest's agreements with the upland owners, during the period here material from which plaintiff received payments from Southwest, computed in accordance with the agreement of the parties dated September 27, 1938, were on upland property owned by Huntington Beach Company, plaintiff herein. Said wells were drilled on a slant toward the ocean and, accordingly, went through and under and owned by the plaintiff herein and land owned or leased by Pacific Electric Railway Company and Pacific Electric Land Company so that the bottoms of said wells were out under the Pacific Ocean.

21. Southwest erected on the lands owned by plaintiff all the ordinary facilities, including its field office, settling and shipping tanks, pipelines, and other equipment and appliances required in connection with its business operations. Under the provisions of State Easement No. 392 it was required that each well be drilled by slant drilling from the uplands to and into the subsurface of the State lands covered by State Easement No. 392. All subsurface operations in connection with the drilling and operation of the wells covered by State Easement No. 392 on account of which plaintiff received payments from Southwest were conducted from and through the land owned by plaintiff herein and through land owned or leased by Pacific

Electric Railway Company and Pacific Electric Land Company.

22. Huntington Beach Company, plaintiff herein, and other upland owners, in accordance with the agreements dated August 25, 1938, and the agreement dated September 27, 1938, received payments during the taxable year which were referred to in the September 27, 1938, agreement as "an amount equal to the following percentages of the 'net profits' " from the operation of the wells here involved as shown below:

Huntington Beach Company	17.75 %
Pacific Electric Railway Company	1.576 "
Pacific Electric Land Company	5.174 "
	24.5 %

23. The following tabulation shows the amount paid to the plaintiff by Southwest in the year 1948, and the manner in which that amount was determined:

1948

Total Southwest Income from State Easement No. 392	$19,148,536.60
Chargeable Expenses	11,834,605.01
Southwest's Net Income	7,313,931.59
Amount paid to Huntington Beach Co. in accordance with agreement	1,298,222.85

24. Under the terms of the Notice issued by the State Lands Commission and referred to in find-

ing 10, each bidder, as a condition precedent to the consideration of his bid for State easement, was required to present evidence satisfactory to the State Lands Commission of his present ability to furnish all necessary sites and rights-of-way without cost or obligation to the State for all operations contemplated under the provisions of the form of bid for State easement to be submitted to the State Lands Commission and any bid not accompanied by such evidence would be rejected by the Commission.

25. The evidence of each bidder's present ability to furnish the above-mentioned sites and rights-of-way had to include (1) an endorsement on the Agreement for State Easement by the owner or owners of the real property described as "uplands" in said agreement that the bidder has been granted all such necessary sites, rights-of-way and easements, and (2) the originals or certified copies of the instrument or instruments vesting is such bidder such sites, rights-of-way and easements.

26. The parties to the August 25, 1938, agreement referred to in finding 13, identified therein as Permittors, were the owners of all of the uplands or littoral lands identified as such in the Notice and the Agreement for State Easement No. 392. Under the terms of that agreement of August 25, 1938, the Permittors granted to Southwest the necessary easements, rights and rights-of-way over, on, and through their uplands for the conduct of Southwest's operations under the form of Agreement for State Easement submitted to the State Lands Com-

mission by Southwest for the extraction of oil, gas and other hydrocarbon substances from the area of State-owned tide and submerged lands described in the Notice issued by the State Lands Commission. The easements, rights and rights-of-way granted Southwest in said agreement by the Permittors remained in effect only during such time as the State easement, or any modification, renewal, extension of, or substitute therefor, was in force and effect.

27. Under the terms of the second agreement referred to in finding 14 executed on August 25, 1938, by the plaintiff herein, Pacific Electric Railway Company, a corporation, Pacific Electric Land Company, a corporation, and Standard Oil Company of California, a corporation, as upland owners and referred to as Permittors and first parties, and Southwest, as second party, and referred to as Permittee, the parties agree (1) that the surface location and subsurface course of Permittee's wells drilled through the uplands pursuant to the State easement shall be agreed upon by Standard Oil Company of California, a corporation (Standard), and Permittee; (2) that all drilling schedules of Permittee and all redrilling, deepening and other work, designed to change the subsurface course or location of Permittee's wells through the uplands shall not be undertaken without Standard's prior approval; (3) that the location of all surface facilities, the quality of all equipment to be used by Permittee in connection with such facilities and the manner of performing all drilling and other opera-

ons by Permittor shall be first approved by the
ermittors.

28. That agreement also provided (1) that South-
est (Permittee) should, upon request, furnish
tandard, et al., copies of logs, record of well cores,
ectrical logs or surveys, water entrance surveys,
lats and surveys showing the location and course
f each and every well drilled by Southwest through
he uplands pursuant to the State easement and all
ther technical information and data concerning
aid wells. Under the terms of that agreement
he rights granted by the Permittors were per-
onal to Southwest, nonassignable without the con-
ent of the Permittors and binding upon the suc-
essors and assigns of the parties to said agree-
ent.

29. The Agreement for State Easement No. 392
onformed to the terms and provisions of the State
ands Act of 1938 and granted Southwest an ease-
ent to extract, remove and produce from the State
nds, oil, gas and other hydrocarbon substances
hrough wells to be drilled, operated and main-
ained by Southwest, the tops of which wells were
equired to be located on the littoral lands or up-
nds described in the Notice for bids issued by the
tate Lands Commission and owned by the parties
dentified as Permittors in the agreements of Au-
ust 25, 1938, referred to in findings 13 and 14.

30. On September 27, 1938, Southwest entered
nto the agreement, referred to in finding 18, with
laintiff and other upland owners. This agree-
ent supplemented the prior agreements of Au-
ust 25, 1938, and provided a manner of commu-

tation and distribution of rental for the rights and privileges given by the upland owners to Southwest in the August 25, 1938, agreements. Under said September 27, 1938, agreement as sole consideration to plaintiff for permission to use its uplands in the manner provided by the August 25 agreements, Southwest agreed to pay plaintiff, as one of the upland owners, an amount equal to 17.75% of the net profits from the extraction of oil and gas from the wells covered by State Easement No. 392.

31. The September 27, 1938, agreement provided for the calculation of net profits as gross proceeds from Southwest's operations in a designated portion of the State lands, minus chargeable expenses, and the gross proceeds included the sale value of all oil produced and saved and all gas produced and sold and 50 percent of all gasoline extracted from gas, minus State reserves, plus proceeds of rentals, etc., the cost of which had been a chargeable expense. Under the provisions of said agreement chargeable expenses included all normal operating costs.

32. Under the applicable provisions of the State Lands Act of 1938 and the corresponding provisions of the Public Resources Code and the terms of the Notice, the use of the uplands adjacent to the area covered by the Notice and State Easement No. 392 was necessary for purposes of mineral extraction from said State Easement No. 392, and without the use of the surface of the uplands there could be no extraction of oil and gas from said State Easement No. 392.

33. Through their control over production of oil and gas from State Easement No. 392, the upland owners or their Permittees were the only parties qualified to bid for State Easement No. 392. The plaintiff possessed an economic interest in the production and sale of oil and gas from State Easement No. 392.

Conclusion of Law

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes that as a matter of law the plaintiff is entitled to recover and it is adjudged and ordered that plaintiff recover of and from the United States the sum of one hundred eighty-two thousand eight hundred two dollars and ninety-eight cents ($182,802.98) with interest according to law.

BRIEF FOR THE U.S.

No.

287

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No. 287

In the Supreme Court of the United States

OCTOBER TERM, 1955

THE UNITED STATES, PETITIONER

v.

HUNTINGTON BEACH COMPANY, A CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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In the Supreme Court of the United States

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THE UNITED STATES, PETITIONER

v.

HUNTINGTON BEACH COMPANY, A CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The findings of fact (R. 63-70), conclusion of law (R. 70), and opinion (R. 56-62) of the Court of Claims, and the concurring opinion of Chief Judge Jones (R. 62-63), are reported at 132 F. Supp. 718.

JURISDICTION

The judgment of the Court of Claims (R. 70) was entered on July 12, 1955. The petition for a writ of certiorari was filed on August 2, 1955, and was granted on October 10, 1955 (R. 70). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255(1).

QUESTION PRESENTED

Southwest Exploration Company obtained a lease from the State of California to drill for and produce oil from certain submerged lands. By state law, it was required to drill the wells on a slant from uplands adjacent to the coastal area and, as a condition to obtaining the lease, it was required to secure necessary easements from upland owners permitting it to conduct the drilling and production operations from and through their property. In return for securing such easements from certain upland owners, of which the taxpayer was one, Southwest undertook to pay them 24½ percent of its net profits derived from the extraction of oil from the submerged lands.

The question is whether the taxpayer, as one of the upland owners, is entitled to depletion deduction on the payments which it received, as was held by the court below, or whether Southwest Exploration Company was entitled to depletion deductions on the same payments, to the exclusion of the upland owners, as was held by the Court of Appeals for the Ninth Circuit in a companion case involving Southwest Exploration Company and which is also before this Court on certiorari in No. 286.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and Regulations (Sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939, Sections 87(a) and 89 of California State Lands Act of 1938, Statutes of California (Extra Session 1938), c. 5, and Section 29.23(m)-1 of Treasury Regulations 111) are set forth in the

ppendix to the brief filed in *Commissioner v. outhwest Exploration Co.*, No. 286, present term.

STATEMENT

The facts in this case were set forth in an agreed tatement, together with exhibits (R. 10-55), and re fully summarized in the findings of fact made the Court of Claims (R. 63-70). The facts ma-rial to a resolution of the issue presented by this se are identical with those involved in *Commis-oner v. Southwest Exploration Co.*, No. 286. Those cts are set forth in the Statement in the Govern-ent's brief in No. 286 (pp. 3-9), and no useful rpose would be served by reiterating them here.

ARGUMENT

As is made clear in the brief filed by the Govern-ent, in *Commissioner v. Southwest Exploration o.*, No. 286, the issue in both cases is identical, mely, is the disputed portion of the depletion duction to be allowable to Southwest Exploration ompany or to the taxpayer and the other upland ners? The Government contends that the iden-al deduction cannot be allowed to both parties d, by the same token, it concedes that the deduc-n cannot be disallowed to both parties.

The Government's position respecting the proper lution to the tax problem posed by those two cases set forth in its brief filed in *Commissioner v. outhwest Exploration Co.*, No. 286, and need not repeated here. In short, our position is that the duction should be denied to Southwest Explora-n Company and should be granted to the upland

owners. Acceptance of the Government's position would lead to the conclusion that the Court of Claims arrived at the correct decision. However, if this Court should disagree with the Government's views in the *Southwest* case, then it would follow that the taxpayer in this case is not entitled to the deduction and that the decision of the court below is wrong.

CONCLUSION

If, as the Government believes to be proper, this Court should reverse the decision of the Court of Appeals for the Ninth Circuit in *Commissioner* v. *Southwest Exploration Co.*, No. 286, the decision of the Court of Claims in the present case should be affirmed. If, however, the judgment of the Ninth Circuit should be affirmed, consistency would require reversal of the judgment of the Court of Claims here.

Respectfully submitted.

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NOVEMBER, 1955.

BRIEF FOR RESPONDENT IN OPPOSITION

MICROCARD
TRADE MARK ®

MATTHEW BENDER & COMPANY MB

No.

287

In the Supreme

OF THE

United States

OCTOBER TERM, 195

No. 287

BRIEF FOR RESPONDENT IN OP

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Sec. 114(b)(3) .....

Treasury Regulations 111:

Sec. 29.23(m)-1 .....

Sec. 29.23(m)-1(b) .....

California Public Resources Code (California State Lands Act) Vol. 2, Div. 6 .....

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1955

No. 287

THE UNITED STATES OF AMERICA,
Petitioner,

vs.

HUNTINGTON BEACH COMPANY,
a corporation,
Respondent

BRIEF FOR RESPONDENT IN OPPOSITION.

OPINION BELOW.

The findings of fact and conclusion of law and the opinion of the Court of Claims and the concurring opinion of Chief Judge Jones are not yet reported.

QUESTION PRESENTED.

The question presented is whether respondent was entitled to deduct percentage depletion on its share of the

net profits from production of oil and gas by Southwest Exploration Company (hereinafter referred to as "Southwest") from California State Easement No. 392, said net profits being derived solely from the production of oil and gas from wells located on respondent's uplands and slant drilled in the State-owned tide and submerged lands off coastal California adjacent to respondent's uplands.

STATEMENT OF THE CASE

Respondent adopts, for the purposes of this brief, the statement of facts by petitioner. We emphasize, however, that the California statute dealing with the exploitation of oil deposits in the State-owned tide and submerged lands (Cal. Pub. Res. Code, Vol. 2, Div. 6) provides that any lease of submerged State land must contain a provision to the effect that:

> "Each well drilled pursuant to the terms of such lease shall be drilled only upon filled lands or shall be slant drilled from an upland or littoral drill site to and into the subsurface of the tide or submerged lands covered by the lease."

We further emphasize that, in accordance with the California statute, Southwest located all surface structures and appliances on respondent's uplands. All drilling operations required in oil and gas production from the State easement were conducted by Southwest from the uplands owned by respondent.

ARGUMENT

The Government advances as reasons for granting the writ:

(1) That the decision below is in conflict with the decision of the Court of Appeals for the Ninth Circuit in *Commissioner of Int. Rev. v. Southwest Exploration Co.* (9 Cir. 1955) 220 F.2d 58 (No. 286, October Term, 1955, on the docket of this Court).

(2) That the conflict between the decisions of the court below and the Court of Appeals is the result of divergent views concerning the meaning of the decisions of this Court in *Kirby Petroleum Co. v. Comm'r.* (1946) 326 U.S. 599 and *Burton-Sutton Oil Co. v. Comm'r.* (1946) 328 U.S. 25 and the earlier decisions of this Court in *Helvering v. O'Donnell* (1938) 303 U.S. 370 and *Helvering v. Elbe Oil Land Co.* (1938) 303 U.S. 372; and

(3) That the decision below presents a question of importance to the revenue.

It is true that the decision of the court below conflicts with the decision in *Commissioner of Int. Rev. v. Southwest Exploration Co.* (9 Cir. 1955) 220 F.2d 58. Most respectfully we urge, however, that the petition for a writ of certiorari in this case should be denied, for the reason that the decision below is clearly correct, accurately applies the decisions of this Court in the *Kirby Petroleum Co.* and *Burton-Sutton Oil Co.* cases, and is in accordance with the position of the Government in the *Southwest Exploration* case, and with the well-settled administrative construction of the depletion provisions of the Internal Revenue Code since the decisions in the *Kirby Petroleum* and *Burton-Sutton* cases.

Section 23(m) of the Internal Revenue Code of 1939 provides that there shall be allowed as a deduction in computing net income in the case of oil and gas wells a reasonable allowance for depletion. Section 114(b)(3) of the Internal Revenue Code of 1939 provides:

> "*Percentage depletion for oil and gas wells.* In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property."

Section 29.23(m)-1, of Regulations 111 provides that "the property" referred to in section 114(b)(3) means the interest owned by the taxpayer in any "mineral property," which is defined as follows:

> "* * * the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction."

It is settled, of course, that only a taxpayer with an economic interest in the oil and gas in place is entitled to percentage depletion. But an economic interest in the "mineral property" does not mean title to, or ownership of, the mineral deposit. The allowance is not made dependent upon the particular form of the taxpayer's interest in the property to be depleted, nor is it dependent upon a retention of ownership or any other particular form of legal interest in the mineral content of the land.

Palmer v. Bender (1933) 287 U.S. 551;

Burnet v. Harmel (1932) 287 U.S. 103.

ng alone, was sufficient to entitle the holder to per-
depletion. The important requisite for an economic
t, the Court held, was the retention of "valuable
s arising from and dependent upon the extraction of
" received as consideration for granting the oper-
control over the exploitation of the land."

California State Lands Act of 1938 placed respond-
a position where its assent to the use of its lands
quired before production could take place from the
osits lying in the adjacent State-owned submerged
The Act provided that all wells must be slant
from an upland site into the subsurface of the
ds covered by the lease. All surface structures,
ent and appliances were required to be located
the uplands and all surface operations conducted
rom.

suant to the State statute the call for bids required
idder to present satisfactory evidence of his pres-
ility to conduct all drilling and surface opera-
from the uplands adjoining the area covered by
tate easement. This was done and under the re-
agreements Southwest granted to respondent a
in the net profits of production in consideration for
e of its uplands in the production.

interrelationship of the contracts obtained by
west from the State and the upland owners is force-
emphasized in the concurring opinion of Chief
Jones of the court below. Chief Judge Jones

woven; that neither of the contracts was self-sufficient to enable Southwest to produce oil and gas from the tidelands area.

The uplands constituted a part of the "mineral property" the gross income from which is subject to depletion. The regulations define the "mineral property" as "the mineral deposit * * * and so much of the surface of the land only as is necessary for purposes of mineral extraction" (Regs. 111, sec. 29.23(m)-1(b)).

Applying this Court's decisions in *Kirby Petroleum* and *Burton-Sutton Oil Co.*, that a contractual relationship is sufficient to support the right to depletion if the possibility of profit depends solely upon the results of production, the Court of Claims correctly concluded that respondent possessed the essential elements necessary to establish an economic interest and was entitled to deplete its portion of the net profits from the oil and gas production.

The cases of *Helvering v. O'Donnell* (1938) 303 U.S. 370 and *Helvering v. Elbe Oil Land Co.* (1938) 303 U.S. 372 clearly are inapplicable in this case. The payments involved in those cases were received as consideration for the sale of property and not, as is here the case, for the continued use of property in the production of oil and gas.

BRIEF FOR RE-SPOND-ENT

United States

October Term, 1955

No. 287

United States of America,
Petitioner,
vs.
tington Beach Company,
orporation,
Respondent.

BRIEF FOR RESPONDENT.

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1955

No. 287

THE UNITED STATES OF AMERICA,
Petitioner,

vs.

HUNTINGTON BEACH COMPANY,
a corporation,
Respondent.

BRIEF FOR RESPONDENT.

OPINION BELOW.

The findings of fact (R. 63-70), conclusion of law (R. 70) and opinion (R. 56-62) of the Court of Claims, and the concurring opinion (R. 62-63) of Chief Judge Jones, are reported at 132 F.Supp. 718.

The jurisdictional requisites and the question presented are stated in petitioner's brief. The applicable statutes

and regulations are set forth in the appendix to the Government's brief in the companion case of *Commissioner v. Southwest Exploration Co.*, No. 286, present term. The material facts, which were stipulated (R. 10-15, Exhibits, R. 16-55), and which are summarized in the findings of fact of the court below (R. 63-70), are also set forth in that brief.

ARGUMENT

We adopt the statement of the general principles relating to the deduction for depletion which are set out at pages 15 to 20 of the Government's brief in *Commissioner v. Southwest Exploration Co.*, No. 286.

We also adopt the argument, at pages 21 to 37 of that brief, in which the Government contends—in accordance with the decision of the Court of Claims—that respondent, in the particular circumstances of this case, clearly possessed a depletable interest in the mineral property.

The Government further contends (Government's Brief, No. 286, pp. 37-44) that a net profits interest cannot be distinguished from a royalty or an oil payment, and that for this reason alone the decision of the court below should be affirmed. This, also, we believe to be a correct statement of the law. We submit, however, for the reasons given in the Government's brief, and for those hereinafter set out, that the decision of the Court of Claims is clearly correct and should be affirmed regardless of whether this Court deems it appropriate to adopt the Government's second contention as the logical (and desirable) result

shall not, of course, repeat what the Government id in its brief. We do wish to emphasize briefly, r, that it long has been established that the "eco- interest" in a mineral property subject to depletion ot require title to, or ownership of, the mineral . Nor does it depend upon a retention of ownership n any other particular form of legal interest in the l content of the land.

Palmer v. Bender (1933) 287 U.S. 551;
Burnet v. Harmel (1932) 287 U.S. 103;
Kirby Petroleum Co. v. Comm'r. (1946) 326 U.S. 599;
Burton-Sutton Oil Co. v. Comm'r. (1946) 328 U.S. 25, 32-33.

ust include, of course, primarily (and perhaps Government's Brief, No. 286, p. 37, et seq.) the o receive a royalty, a percentage of production, a of the net receipts from production, or a similar t under which the "possibility of profit" or "re- investment" depends solely upon the extraction le of the oil" (*Burton-Sutton Oil Co. v. Comm'r.*, pp. 34-35; *Kirby Petroleum Co. v. Comm'r.*, supra, 3-604). Exactly what additional factor or element, is required to complete an economic interest has en delineated. The "facts of each transaction" een appraised from case to case (*Kirby Petroleum Comm'r.*, supra, p. 606). Certainly, however, as ourt held in *Burton-Sutton Oil Co. v. Comm'r.*,

ic interest is complete.

" * * * the petitioner looked to the special depletion allowances of §114(b)(3) to return whatever capital investment it had * * * Depletion depends only upon production. It is the lessor's, lessee's or transferee's 'possibility of profit' from the use of his rights over production 'dependent solely upon the extraction and sale of the oil,' which marks an economic interest in the oil" (*Burton-Sutton Oil Co. v. Comm'r.*, supra, pp. 34-35).

this case, as the court below pointed out, respond- ad from the outset direct control over the production e oil and gas. This was true under state law. It true under the terms of the state easement. The oil be produced only through wells drilled on and gh respondent's property.[1] At no time did the state or grant to Southwest the unqualified right to pro- oil and gas from the tidelands. Under applicable could not have done so. Grants both from the state rom respondent were necessary to obtain the right

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California Public Resources Code, Vol. 2, Div. 6, provides ery lease of submerged state land must contain a provision effect that:

"Each well drilled pursuant to the terms of such lease all be drilled only upon filled lands or shall be slant drilled on an upland or littoral drill site to and into the subsurface the tide or submerged lands covered by the lease" (Appendix to Government's Brief, No. 286, p. 46).

manner of drilling is diagrammatically presented in Exhibit he Stipulation of Facts, R. 51A.

situs of the oil put it in a position to prevent the production of the oil, or to permit its production on prescribed terms (R. 60).[2]

In a single integrated transaction (or, as Chief Judge Jones put it, by "contracts * * * tied together [which] became a part of the warp and woof of the same garment" (R. 63)), the parties entered into the agreements which made possible and provided for the production of the oil and gas.

By these interrelated agreements the state gave the qualified easement, respondent dedicated its uplands to the production of the oil and gas, and Southwest agreed to pay to the state a royalty and to respondent, as "sole consideration" for its upland rights, "an amount equal to 17.75% of the net profits from the extraction of oil and

---

[2] "Under the applicable provisions of the State Lands Act of 1938 and the corresponding provisions of the Public Resources Code and the terms of the Notice, the use of the uplands adjacent to the area covered by the Notice and State Easement No. 392 was necessary for purposes of mineral extraction from said State Easement No. 392, and without the use of the surface of the uplands there could be no extraction of oil and gas from said State Easement No. 392" (Finding 32, R. 69).

"Through their control over production of oil and gas from State Easement No. 392, the upland owners or their Permittees were the only parties qualified to bid for State Easement No. 392. The plaintiff possessed an economic interest in the production and sale of oil and gas from State Easement No. 392" (Finding 33, R. 70).

iare of the profits granted to respondent—in both in-
ances, it was the amount paid by Southwest in order
o obtain the right to produce the oil; in both instances
As oil was taken out, [the] prospects for future income
ould diminish, because of the depletion of the source of
he] income" (R. 60).

Further, respondent under its agreement with South-
est reserved significant elements of control over produc-
on. The surface location and subsurface course of each
ell was made subject to the approval of Standard Oil
ompany of California, one of the permittors; drilling
as required to conform to good oil field practice; South-
est was required to furnish to the upland owners—whose
le return was to come from the oil produced—"copies
logs, records or well cores, electrical logs or surveys;
* * together with complete information as to the loca-
on, course, mechanical condition, pressures, water shut-
ffs, oil, gas and water production, perforations, condi-
ons, fluid levels, depth pressures, size of pump, length
d speed of stroke, and other facts relative thereto," and
give access, as to each well, "to all records and survey
ata pertaining thereto as to the history, location, course,
echanical condition, equipment, pressures, water shut-
ffs, oil production, perforations and condition of said
ell" (R. 23-24).

In these circumstances it cannot, we submit, be doubted
at respondent "in all reality" (R. 60) had an economic
terest in the oil. As the court below pointed out (R. 59-
0), respondent, with respect to the use of its land for

quisition of the right to produce and to the production
elf, it is immaterial whether production takes place
rough vertical drilling or slant drilling, or whether the
deposit underlies the land on which the wells are
ated. Where such rights are granted in consideration
a share of the net profits of production, the owner of
e surface has an economic interest in the oil.

As the court below said (R. 59-60):

> "From a legal viewpoint the plaintiff, because of its ownership of the strategic upland, had a legal right to say to the prospective operator, 'You cannot produce oil from these lands of the State unless you pay me 17¾% of your net profits' * * *.
>
> * * * * * *
>
> It could, no doubt, have sold its land for a much higher price after the discovery of oil which could be recovered only through its land. It chose to make the arrangement whereby its return would depend upon the recovery of oil through wells on its land, and its prospect for future return would diminish as the oil was taken out. In all reality, the plaintiff had an economic interest in the oil."

Further, and in confirmation of the "realities" of the
ituation, respondent's uplands here constitute a part of
he "mineral property" subject to depletion within the
pecific definition in the Treasury Regulations construing
he depletion provisions of the Internal Revenue Code.
Section 114(b)(3) of the Code provides for depletion in
he case of oil and gas wells of "27½ per centum of the

286, p. 46).

ction 29.23(m)-1(i) provides that:

"'The property,' as used in section 114(b)(2), (3) and (4) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property * * *" (Appx. to Government's Brief, No. 286, p. 49).

nd section 29.23(m)-1(b) of Regulations 111 defines ral property as:

"* * * the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction" (Appx. to Government's Brief, No. 286, p. 48).

in this case, as the Government points out in in No. 286 (p. 21), the amounts paid by Southwest espondent are "rents or royalties paid or incurred he taxpayer in respect of the property," they cannot ncluded in Southwest's gross income from the pro on which depletion is computed, but instead are sub to depletion by respondent. Under the Regulations atter must be so, for respondent's land is "so much he surface of the land * * * as is necessary for pur s of mineral extraction."

either *Helvering v. Elbe Oil Land Co.* (1938) 303 U. nor *Helvering v. O'Donnell* (1938) 303 U.S. 370,

ings the annotator says:

"In the instant case, the upland owners clearly became entitled to a share of income derived from exploitation of the leased property and dependent solely upon that share and its source for the return of their capital investment, or in any case, for their 'possibility of profit'." [p. 66].

* * * * * *

* * * these upland owners had made a real and substantial capital investment—they had dedicated their upland properties as a situs for Southwest's operation, an action resulting in impairment of their unrestricted use of their properties. As for the value of the dedication, that is easily and irrefutably demonstrated by the grant of a 24½% unburdened share of Southwest's net profits from the submerged coastal lands as consideration therefor [p. 68].

* * * it appears that the treatment of the depletion issue in this case is not correct either in result or analysis" [p. 69].

* * * * * *

Similar views are expressed in the Report of the Committee on Natural Resources of the American Bar Association, published prior to the decision of the Court of Claims in the case at bar:

"The net profits interests obtained by the drill site owners in this case appear to be as much of an economic interest in the oil and gas in place as that obtained by holders of net profits interests acquired in more usual oil and gas transactions. The determination that the drill site owners had no 'capital investment' ignores the fact that they had made a substantial contribution to the production of the oil and gas by dedicating their properties as sites for the drilling operations, which action certainly resulted in an impairment of their right to unrestricted use of their respective properties. The affirmation of the Tax Court decision in this case certainly casts doubt as to the tax status of many other net profits interests in common use in the oil and gas industry" (American Bar Association, Section of Taxation, Program and Committee Reports, Presented 16th annual meeting, August 18-24, 1955, Philadelphia, Pennsylvania, pp. 80-81).

Mertens, Law of Federal Income Taxation, 1954 Ed., Vol. 4, 25a, note 10 (published prior to the decision of the Court of ms in the case at bar) the decision of the Tax Court in the *thwest Exploration Co.* case is stated, with this *caveat:*

"After analyzing the terms of the taxpayer's [Southwest's] separate agreements with the Commission and the upland owners, the Tax Court held that the amounts paid to the

ion would be simply that neither would there-
e profits on which it could claim depletion.
dent during the taxable years did not occupy
ip relationship with Southwest and could not
produced the oil is also immaterial. This ordi-
ld be true of the royalty holder who has
most common form of depletable interest.
hnical questions of title and ownership, as we
(supra, p. 3), have long since been held

echnical title to the oil in place is not impor-

* * * * * *

Economic interest does not mean title to the
place but the possibility of profit from that
ie interest dependent solely upon the extrac-
d sale of the oil" (*Kirby Petroleum Co. v.*
. (1946) 326 U.S. 599, 603, 604).

CONCLUSION

For the reasons above stated and for the reasons set ıt in the Government's Brief in *Commissioner v. South-est Exploration Co.*, No. 286, the decision of the Court Claims should be affirmed.

Dated, San Francisco, California,
December 23, 1955.

Respectfully submitted,

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SUPPLEMENTAL BRIEF

No.

287

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1955

No. 287

THE UNITED STATES OF AMERICA,

Petitioner,

vs.

HUNTINGTON BEACH COMPANY, a corporation,

Respondent.

SUPPLEMENTAL BRIEF.

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In the Supreme Court
OF THE
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October Term, 1955

No. 287

THE UNITED STATES OF AMERICA,
Petitioner,

vs.

HUNTINGTON BEACH COMPANY,
a corporation,
Respondent.

SUPPLEMENTAL BRIEF.

STATEMENT.

Since the filing of respondent's brief in chief, respondent has received a copy of the brief for the Southwest Exploration Company in the companion case, Docket No. 286, the issue in which is identical with that involved in this case. This supplemental brief discusses certain contentions made by Southwest which were not available for comment by respondent when it filed its brief in chief.

ARGUMENT

1. *Huntington Beach was dependent solely on the proceeds of production of oil and gas for its share of the net profits.*

Southwest contends that the upland owners' right to receive a percentage of the net profits was a personal obligation which might have been paid out of Southwest's capital and not payable solely out of net profits from the oil operations (Southwest Br., p. 18). Southwest points to the provisions of the agreement between the upland owners and Southwest stipulating that none of the net profits payments paid to the upland owners should be returned to Southwest in the event of a subsequent loss in the development or operation of the state lands (R., No. 286, 70-71; R., No. 287, 49). Here it is clear that Huntington Beach and the other upland owners derive their share of the net profits solely from the proceeds of the oil and gas produced by Southwest. The fact that the upland owners do not share any subsequent operating losses of Southwest does not alter their dependence on production for their share of net profits. Profits must necessarily be computed from time to time for stated accounting periods and are nonetheless profits, even though subsequent losses occur. In this regard the share of the upland owners in the profits of production does not differ from that of the holders of net profits interests in *Kirby Petroleum Co. v. Comm'r.* (1946) 326 U.S. 599, and *Burton-Sutton Oil Co. v. Comm'r.* (1946) 328 U.S. 25, since in those cases, as here, such holders did not share in subsequent losses from operations.

2. *A share in the "right to produce," as contended by Southwest, is not essential to depletion.*

The principal basis on which Southwest rests its case is its theory of the depletion deduction, which is manifestly different from the accepted concept of depletion which is set out in the opening portion of the Government's main brief (Southwest Br., p. 16; Government's Main Br., pp. 15-20). Southwest points to the fact that the upland owners had no right to produce oil and gas from the lands covered by the State Easement, and it urges that this Court accept the doctrine that percentage depletion is limited only to taxpayers entitled to produce. This theory fashioned by Southwest is summarized as follows (Southwest Br., p. 33):

> "The theory of depletion established by this Court limits depletion deductions to those who receive income from a mineral property and (a) have a right to enter, drill and extract the natural resource or (b) to those having that right who appoint others to carry on that work but retain control over the work by becoming partners or tenants in common with the assignee, or by having a reversionary interest in that right to enter, drill and produce."

At the outset it should be noted that Southwest did not derive from the state alone the right to enter, drill and produce the oil and gas. As the concurring opinion of the court below pointed out (R., No. 287, 62-63) the state did not grant to Southwest an unconditional lease. Southwest was granted an easement through, in and under the tidelands, with the right to produce oil and gas only from wells to be drilled and operated on the uplands. To

make effective the grant to Southwest by the state it was necessary for Southwest to obtain from the upland owners their grant to enter their lands and produce through wells located on their lands. Southwest was not even eligible to bid for the State Easement unless it received such grants from the upland owners (R., No. 287, 70). As the court below held, their legal and physical relation to the state tidelands enabled them to prevent production by Southwest or to permit its production on prescribed terms. In a very real sense the upland owners shared in the granting to Southwest of its right to produce when they surrendered their control over production for a share in the net profits.

However, a further and complete answer to Southwest's contention is that in no one of its decisions has this Court stated that depletion is limited to taxpayers having a right to produce, present or future. On the contrary, this Court has repeatedly declared that the depletion deduction is not controlled by property concepts or by matters of form, or the niceties of conveyancing. Thus, in *Palmer v. Bender* (1933) 287 U.S. 551, this Court stated as follows (p. 557):

> "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital."

In that case this Court found the distinction between an assignment and a sublease immaterial in determining

whether a taxpayer had a depletable interest. The Government contended that the taxpayers had no reversionary interests in the oil and gas leases under the Louisiana law, on the ground that they had entered into assignments rather than subleases. This Court held that their rights to depletion did not depend on whether they were technically sublessors, but depended solely upon their economic relation to the property. This Court held that the taxpayers' right to a share in the oil produced gave them an economic interest in the oil which entitled them to depletion.

Southwest, in its reliance on the right to produce as essential to depletion, misconceives the nature of the doctrine of economic interest which has been established by the decisions of this Court. It is a share in the *proceeds of production* that marks an economic interest, as this Court has reiterated in the *Burton-Sutton* case, not a share in the *right to produce*, as urged by Southwest. To let the depletion allowance turn on a reversionary interest in the right to produce would, in the language of this Court in the *Burton-Sutton* case (328 U.S. 32), "make the right to depletion a form of words."

The right to produce has significance only if minerals can be economically extracted. If the mineral content of the land has been exhausted by production or the lands are not commercially productive, the mere right to produce is without substance. That the economic incidents of mineral production alone control the depletion allowance is manifest from the decision of this Court in the *Burton-Sutton* case. There this Court refused to let the

character of the net profit payment for purposes of depletion turn on the ownership of a royalty interest. This Court emphasized that forms of legal relationships or considerations of title were not controlling, but that the essential element of the depletion allowance was a share in the income from production, dependent solely upon the extraction and sale of the oil.

This Court has not considered a reversionary interest in the right to produce as controlling or even material in determining who was entitled to depletion. In *Thomas v. Perkins* (1937) 301 U.S. 655, the right to oil payments up to a limited sum was held to be depletable, and this Court found no occasion to discuss whether the assignor had retained any future right to produce or if so retained whether such right to produce was of any substance, in view of the limited nature of the oil payments reserved.*

The emphasis placed by this Court in the *Kirby* and *Burton-Sutton* cases on the right to share in the income from production supports the view that the share in net profits from production which Huntington Beach and the upland owners possessed, in and of itself is sufficient to provide them with an economic interest independent of the circumstances out of which it arose, but where

*In *Herring v. Commissioner* (1934) 293 U.S. 322, in dealing with the allowance of depletion on lease bonus payments, this Court stated as follows (p. 327):

> "To condition the allowance on actual production, however small, or the imminent probability of production and to deal in refinements as to the degree of probability of future production, is in many cases to deny any deduction where the taxpayer elects to compute it under 204 (c) (2), flat percentage of gross income from the property and permit it where he elects to compute it under 204 (c), on the basis of cost."

such share arises from the control over production held and exercised by the upland owners and in consideration of the grant of the use of their property in production, the recognition of the economic interest on the part of the upland owners clearly falls within the principles laid down by this Court in the *Kirby* and *Burton-Sutton* cases.

3. *No double depletion deduction to the upland owners is involved here.*

Southwest suggests that the allowance of a depletion deduction on the net profits payments received by the upland owners would give it two depletion deductions as the owner of one property (Southwest Br., pp. 24-25). It points to the fact that the surface of the uplands is used by Standard Oil Company as lessee in producing through vertical wells from the oil and gas deposits directly underlying the uplands (Southwest Br., pp. 24-25). This contention is based on an erroneous view of the nature of the property interest with respect to which depletion is allowed. The depletion allowance is made with respect to gross income from mineral property, and it has long been recognized that mineral property for purposes of depletion is not controlled by the metes and bounds of parcels of real property under which mineral deposits may lie. In the situation presented here there were two producing zones containing oil and gas deposits underlying both the uplands and the tidelands. These were known as the "Main Zone" and the "Jones Zone" (R., No. 287, 13-14). Huntington Beach, by virtue of its lease with Standard Oil, shared in the production from these two zones underlying its uplands and was entitled to de-

letion on its share of the gross income from that prop-
rty. The share of the income which it received from
outhwest was from the production of oil and gas from
he same zones underneath the tidelands, which, together
ith the surface of the upland necessary for the extraction
f the oil and gas, constituted a separate mineral prop-
rty. There is, therefore, no question here of a double
eduction for depletion to Huntington Beach on the same
ineral property, since its share of the net profits from
outhwest's production is derived from a separate min-
ral property not a part of the mineral property operated
y its lessee (see *Helvering v. Jewel Mining Co.* (8 Cir.
942) 126 F.2d 1011).

4. *Section 29.23(m)-1 of Regulations 111 does not con-
ol the disposition of this case.*

Southwest contends that the Regulations set forth in
ection 29.23(m)-1 of Regulations 111, cited in the ap-
endix to its brief (Southwest Br. Appx., pp. 1-2) are
alid and that the Government is in effect asking this
ourt to "amend" its Regulations with retroactive effect
Southwest Br., p. 49). These same Regulations were in
orce and before this Court in the *Kirby* and *Burton-
utton* cases, supra. In the *Burton-Sutton* case the Gov-
rnment urged that the Regulations supported its conten-
on that the ownership of a royalty or other interest in
ddition to a net profits interest is essential to provide
depletable interest. This Court squarely rejected that
ontention, and, of course, in so far as the Regulations
re inconsistent with its decision in the *Burton-Sutton*
ase they cannot stand. Quite apart from this, however,

the Regulations in this regard do not reach the case at bar. They do not purport to deny depletion to a taxpayer such as respondent, whose share of net income from production was derived from its control over production and the use of its property in production."

5. *The possibility of changes in the state law or the State Easement does not preclude the existence of an economic interest during the years in question.*

Southwest points to the changes in the State Lands Act set out on pages 7 and 8 of the appendix to its brief, and contends that the upland owners did not derive their share of the net profits from an economic interest but from a legislative act (Southwest Br., pp. 18-19, 46). Like Southwest the upland owners derived their share in the production by reason of agreements entered into under the state law. Without the provisions of the State Lands Act neither Southwest nor the upland owners would have been entitled to any share in the production of the oil and gas from the state lands. The state law provided the necessary authorization for the granting of the State Lease but it also permitted the upland owners alone to determine who would be eligible to bid for the State Lease. Since Southwest received from the upland owners the right to enter their lands and drill in and through their property, Southwest alone was eligible to submit a bid for the State Lease. The fact that the state law now permits drilling into the tidelands by artificially filled lands, or fixed or floating structures, does not change in any way the agreements entered into between the upland owners and Southwest. The state law did not and could

not change the agreement covering the share in the net profits which Southwest has agreed to pay the upland owners. As is shown by section 6 of Exhibit 5 (R., No. 287, 20) and by section 22 of Exhibit 11 (R., No. 287, 41), the agreements covering the grant of the use of the upland owners' property by Southwest and the payment by Southwest of their share in the net profits from production continue in effect as long as the State Easement, or any modification, renewal or extention thereof, is in effect. It is immaterial whether the state law authorizes an agreement for the drilling of vertical wells in the tidelands or that the State Easement may be modified by an agreement between Southwest and the state to permit such vertical drilling. The upland owners are entitled to their specified share of the net profits from production under the State Easement as long as the easement, or any renewal, extension or modification thereof, is in effect. If the easement is terminated then neither Southwest nor the upland owners will receive any profits thereunder on which they can claim depletion. The mere possibility that such termination might occur does not preclude the allowance of depletion to respondent any more than such possibility deprives Southwest of an economic interest under the easement. Far from being temporary or transitory, as suggested by Southwest, the economic interests of the upland owners are coterminous with the economic life of the mineral property, for operations will continue as long as they are profitable, and if they are profitable respondent and the other upland owners will continue to share in the profits.

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San Francisco, Ca

January 13, 1956

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NCLUSION.

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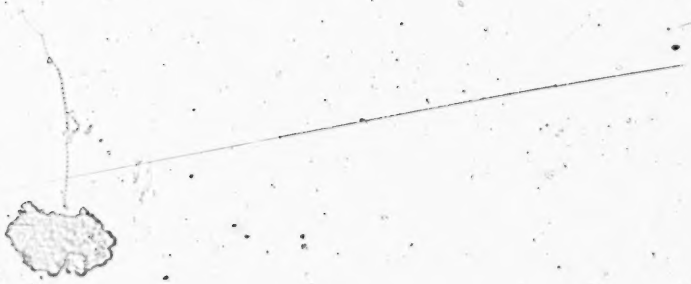

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